



The Commonwealth of Massachusetts
Office of the Comptroller
One Ashburton Place, Room 901
Boston, Massachusetts 02108

MARTIN J. BENISON
COMPTROLLER

PHONE (617) 727-5000

FAX (617) 727-2163

www.mass.gov/osc

MMARS Policy: **Accounts Payable**

Issue Date:

Date Last Revised: **January 2014**

Settlements and Judgments

Executive Summary

The following policies apply to all Commonwealth Branches and Departments processing settlements and judgments. A settlement or judgment results from a formal claim (grievance, complaint or law suit) against the Commonwealth that results in either a Settlement Agreement, or a court or administrative award, order or judgment. Settlements and judgments do NOT include retroactive salary adjustments, unpaid regular time, collective bargaining agreement increases or other routine payroll corrections of errors, or adjustments. Departments may not process payments or adjustments for a settlement, judgment or administrative award as a routine payroll entry, but must follow this policy to ensure appropriate tax reporting, withholdings and funding.

The information contained in this document outlines the Commonwealth's tax reporting, withholding and payment responsibilities for settlements and judgments under 815 CMR 5:00. As the Tax Clearinghouse for Commonwealth payments, the Office of the Comptroller (CTR) is responsible for the appropriate tax reporting and withholding on damage awards to the Internal Revenue Service (IRS) and the Department of Revenue (DOR). Claims must be paid with "legally available funds" as defined by 815 CMR 5.00. CTR will determine the appropriate funding sources for settlements and judgments.

Considerations

The Commonwealth makes no representations as to the tax consequences of a payment and Claimants and Claimant Attorneys are responsible for all tax liabilities and tax consequences of a payment. The Commonwealth will be held harmless as to any tax liabilities of the Claimant. The Commonwealth provides guidance solely on how the Commonwealth will process settlements and judgments and the withholdings and tax reporting forms that will be used to communicate that a settlement or judgment payment has been made.

LIST OF TOPICS IN THIS CHAPTER [in alphabetical order]
Click on title for link to that section

Additional Tax Reporting For Attorney/3rd Party (p.17)	Interest On Damages And Attorney Fees (p. 19)
Administrative Claims (p. 25)	IRS Examples Of Tax Reporting Requirements (p. 33)
Agency Counsel And Department Responsibilities (p. 2)	Legal Representation Costs Indemnification (p. 23)
Attorney Fees And Costs (p. 17)	Limited Tax Exemption For Attorney's Fees And Costs (p. 18)
Back Pay Or Salary Replacement (p.13)	Lump Sum Awards (p. 14)
Back Pay Retirement Contributions (p. 13)	M.G.L. C. 258 Torts (p. 20)
Claim Negotiation Limitations And Recommendations (p. 5)	Payment Options And Authorized Payees (p. 31)
Claimant And Payee TIN/FEIN Mandatory Verification (p. 30)	Potential Claimant Penalties For Unpaid Taxes (p. 35)
Claims Not Subject To Tax Reporting Or Taxes For Claimant (p.)	Processing Steps For Claim Payments (p. 28)
Class Action Special Considerations (p. 21)	Public Records (p. 7)
Communication With Claimant Or Claimant's Attorney (p. 4)	Pulled Checks (p. 6)
Confidentiality Provisions And Public Records (p. 7)	Punitive Damages (p. 20)
CTR Prior Review Claims and Payment Instructions (p. 4)	Records Management (p. 34)
Deferred Compensation Contributions (p. 6)	Required Documentation For Claimants (p. 28)
Department Funds (p. 27)	Retirement Contributions Or Retirement Creditable Service (p. 5)
Electronic Fund Transfer (EFT/Direct Deposit) (p. 31)	Settlement And Judgment Reserve (1599-3384 Or Other S&J Reserve) (p. 26)
Eminent Domain (p. 26)	Tax Reporting Of Settlements And Judgments - Overview (p. 9)
Emotional Distress (p. 11)	Timing Of Payments (p. 5)
Employment Claim Processing Requirements (p. 13)	Tort Claims - Liability Management Reduction Fund (LMRF) (p. 20)
Employment Related Claims – General Information (p. 10)	Types Of Damages And Tax Reporting And Withholding (p. 10)
Front Pay (p. 6)	Vendor Web And Vendor Lookup For Details Of Payments (p. 31)
Funding Sources For Settlements And Judgments (p. 26)	Wages Subject To Withholdings Prior To Payment (p. 12)
Intercept And Wage Garnishments (p. 7)	Wrongful Conviction Settlements Under M.G.L. C. 258D (p. 20)

Policy

To ensure that the Commonwealth meets its tax reporting and withholding obligations, to preserve the prudent use of taxpayer funds, and to protect Claimants, it is the Commonwealth's policy to adopt the most conservative approach related to tax reporting and withholding responsibilities as identified by the IRS or DOR. Therefore, when there is ambiguity as to tax withholding or tax reporting responsibilities, or there are risks of potential tax withholding penalties for ***either*** the Commonwealth or Claimants, the Commonwealth will default in favor of withholding and tax reporting. In addition to insulating the Commonwealth from potentially significant penalties for failure to withhold and report payments, this policy also protects Claimants from incurring significant potential tax liabilities and late penalties when they have to file his/her tax returns, or during the 3 years following the receipt of a settlement or judgment. Departments and Agency Counsels are required to consider this information when negotiating claims resolution and are required to provide notice of these procedures to Claimants, Claimant's Attorney and administrative or Union representatives involved in litigation, administrative procedures (such as MCAD claims) and other grievances or disputes.

A "claim" is considered any demand by any person for damages to compensate a wrong allegedly suffered, including but not limited to violation of civil rights, breach of contract, failure to comply with contract bidding laws, incorrect or improper personnel determinations regarding pay, promotion or discipline, failure to comply with statutory or constitutional provisions applicable to employment, an eminent domain taking, and attorney's fees, interest and litigation costs associated with these claims.

Agency Counsel and Department Responsibilities.

The Agency Counsel, Department Chief Fiscal Officer and Payroll Director are responsible for ensuring that claims against the Commonwealth are negotiated and processed in compliance with 815 CMR 5.00 and policies and instructions issued for Settlements and Judgments, and that all relevant staff are provided with access to these materials and training as appropriate. The following are general requirements:

- When a claim is filed against Department, the Department must immediately submit the claim/or subpoena to Department Legal Staff and the Secretariat General Counsel (if required).
- Administrative claims (such as union grievances) are normally handled internally by the Department HR/Payroll and Legal Staff and the Human Resources Division/Office of Employee Relations as appropriate.

- All subpoenas or other civil litigation complaints filed against the Department should be immediately copied and submitted the same day to the Office of the Attorney General (AGO) Government Bureau.
- The attorney responsible for representing the Department or Commonwealth on a claim (Agency Counsel) will be listed in the **Settlement/Judgment Payment Authorization Form** and be the central point of contact for CTR for questions arising under the claim. If the claim is not handled by an attorney, the Chief Fiscal Officer will be responsible for ensuring compliance with these policies. Departments are encouraged to have legal assistance with all claims against the Department.
- The Agency Counsel is responsible for ensuring that the Claimant or Claimant's Attorney have been provided with the "**Notice of Settlement/Judgment Tax Reporting And Withholdings, Claimant Receipt of W-2, 1099-MISC or 1099-INT Forms**," which includes notice that payments once issued by the Commonwealth may be reduced due to intercept for any outstanding Commonwealth debts (including state or federal taxes, child support, student loans). No claim for non-payment or reduced payment may be brought against the Commonwealth for tax withholdings or intercept.
- The Agency Counsel is responsible for working with the Department CFO and HR/Payroll Director (for claims to be processed through the payroll system- HR/CMS) to process any settlement and judgment once approved by CTR.
- The Agency Counsel is also responsible for ensuring that the Department Payroll Director/Contact person is listed in the **Settlement/Judgment Payment Authorization Form** and is provided with a copy of all paperwork that is submitted to CTR Legal for employment related **back pay, lump sum** and other payments that will be processed through the payroll system.
- Since certain claims may be subject to significant interest for late payment, the Agency Counsel is responsible for ensuring that claims are submitted to CTR with complete documentation and information in a timely fashion, **but in no event later than 2 weeks** from the Agency Counsel's receipt of executed Settlement/Judgment documents, releases, W-9s or tax information.
- The Agency Counsel and Department are required to verify that all tax identification information submitted by a Claimant or other payee has been identified as outlined in this Policy.
- A Stipulation of Dismissal for litigated claims must be executed by the parties in order for a litigated settlement payment to be made, but may be held by the Agency Counsel or Claimant's Attorney until proof of payment when the Stipulation of Dismissal will be filed with the relevant court.
- If the Agency Counsel is from the Office of the Attorney General (AAG) or an appointed SAAG, the Agency Counsel must work with the Department Legal and Fiscal staff to ensure that complete paperwork is submitted to CTR for processing.
- The Agency Counsel must track any paperwork submitted to the Department for signature (e.g., Settlement/Judgment Payment Authorization Form) and ensure that the signature process is expedited to ensure timely filing of claims for payment.
- The Agency Counsel is responsible for all communications with Claimant and Claimant's Attorney, including questions related to how the Commonwealth will process tax reporting or withholdings.
- The Agency Counsel is responsible for ensuring that the Department maintains the originals/record copy of all documents related to a claim for the applicable retention period. Copies of claims will be submitted to CTR for processing but will be maintained solely for administrative processing purposes through the normal audit cycle.

Please Note: CTR sends emails to the Payroll Director, Chief Fiscal Officer and General Counsel listed on our Department Contact List. See: [Statewide Key Contact Lists](#). **PLEASE MAKE SURE YOUR PAYROLL DIRECTOR, CFO AND LEGAL COUNSEL DESIGNATIONS ARE UP-TO-DATE.**

If these designations have changed, or will be on extended leave, please have your Department Head designate an alternative using the form at:
http://www.mass.gov/Aosc/docs/Forms/Security/Dept_Key_State_Finance_Law.doc

Communication with Claimant or Claimant's Attorney.

Departments and Agency Counsels may NOT refer a Claimant or Claimant's Attorney to CTR for resolution of questions related to a Settlement or Judgment. CTR has no authority to make representations on behalf of any Department and will refer all questions related to a claim back to the Agency Counsel for resolution. CTR will work with the Agency Counsel, or if not represented by Attorney, with the Chief Fiscal Officer to resolve any questions related to the payment or processing of a settlement or judgment. CTR will not communicate directly with a Claimant or Claimant's Attorney to identify the payment options, the timing of payment, or to resolve any questions related to payment, including the tax reporting, withholdings or tax treatment of the payments. When questions on tax reporting or withholding arise a copy of this document or other related references may be provided to a Claimant, Claimant's Attorney, union representative, arbitrator or court.

CTR processes claims "on behalf of" a Department which is based upon the Department's certification and request for processing, or request for approval for processing by the CFO and Legal Counsel on the Settlement/Judgment Authorization Form. Therefore, CTR has no authority to represent a Department and cannot speak to a Claimant, Claimant's Attorney, a Union representative or any other individual related to a claim.

CTR Prior Review of Settlement and Judgment Payment Instructions.

All "monetary" settlements/judgments **must** be reviewed by CTR prior to payment to ensure that the payments are made using the appropriate codes and that proper tax withholdings and tax reporting are made, ***irrespective of whether or not the Department plans to pay the claim with Department funds or through the Settlement and Judgment Reserve (1599-3384) or other authorized account.***

A "monetary" settlement or judgment includes any action which results in a payment being made to, or on behalf of a Claimant, or which may impact "creditable" service for retirement calculation purposes for a state employee, or which may result in a future commitment of funds, services or state resources.

- A settlement or judgment on an employee grievance which makes an adjustment to vacation or sick time or other leave (which does not have any associated payments, reimbursements or changes in creditable service) will be considered a "non-monetary" settlement or judgment which does not have to be reviewed by CTR prior to the payroll adjustment. (Note that payroll "adjustments" may not be made in lieu of back pay or other salary payments, and may not be made for leave that has not actually been earned, accrued or for time actually worked.)
- A settlement or judgment on an employee grievance which reinstates, promotes, or makes an employee "whole" for a number of days is a "monetary" settlement or judgment" and must be reviewed by CTR for the proper processing instructions. These amounts may not be processed as regular payroll payments using regular pay or any other payroll earnings codes to avoid the CTR approval process, to make payments from current payroll funds which are not authorized by CTR or to avoid the settlement process.
- A settlement or judgment awarding attorneys fees or any payment to a 3rd party (even if no payments are being paid directly to a Claimant) are considered a "monetary" settlement or judgment (because the award is being made to the Claimant even if the "payment" is being made to another person or firm) and must be reviewed by CTR for the proper processing instructions. Attorneys fees may NOT be paid as regular legal fees under the HH object class.
- A settlement or judgment for a "consent decree" or "court monitor assignment" which will result in an ongoing commitment of funding, services, a sustained level of services or other mandate for Commonwealth participation will be considered a "monetary" claim and must be reviewed by CTR for the proper processing instructions. In addition, these settlements or judgments may not be negotiated or finalized without participation from ANF or the appropriate budgetary authority to confirm funding availability for these types of claims. No

state official has the authority to incur a future obligation on behalf of the Commonwealth without a 2/3rds vote of the Legislature and funding will be subject to appropriation process. **Please see Section below on Special Appropriations for additional funding requirements.**

With limited exceptions, all claims are subject to tax reporting which IS NOT NEGOTIABLE. Tax reporting does not mean that the amounts are automatically taxable, but merely that the Commonwealth is required to report to the IRS and DOR that these amounts were paid and to whom the payments were issued (under which tax identification number – TIN or FEIN).

CTR will determine how payments will be processed to meet the terms of a claim, to meet tax reporting and withholding requirements and in the most cost effective and efficient manner for the Commonwealth. Claims submitted for payments must be submitted in accordance with the tax reporting and withholding requirements outlined in this Policy.

CTR will conduct reviews of payments made by Departments using Settlement and Judgment codes and will conduct Quality Assurance reviews and audits as deemed appropriate. Departments will be responsible for making any corrections necessary to bring any settlements or judgment documentation or payments into compliance if a Department makes a payment contrary to the instructions in this Policy.

Claim Negotiation Limitations and Recommendations

Departments are responsible for negotiating or litigating claims in the most cost effective manner for the Commonwealth. Please note the following limitations to what can and can not be supported when CTR processes a claim. The following items ARE NOT NEGOTIABLE as part of a settlement or judgment:

- **Taxability, tax reporting or withholdings as part of a claim.** CTR does not determine whether a claim is taxable, but only whether the claim is tax reportable and if tax withholdings are required. CTR will process claims in accordance with applicable state and federal tax reporting policies and statutes which have been outlined in this Policy. Settlements and Judgments may NOT be negotiated to make deferred payments across multiple fiscal years in an attempt to obtain alleged tax treatment. The IRS has severely restricted the types of income that may have tax deferred payments. The Commonwealth has determined that all settlements and judgments will be constructively received in the tax year in which payments are issued and not when cashed by a claimant or attorney. Therefore, a claim that attempts to defer payment across multiple fiscal or tax years will be treated as constructive received in the tax year the settlement's first payment is issued and the entire settlement amount will be reported by CTR for that calendar year.
- **Timing of Payments.** Payment deadlines or the timing of payment for claims paid from the S&J Reserve or any other fund are not negotiable. Payments are processed "first in complete, first out paid" based upon the date when a claim is submitted to CTR for processing, AND subject to the claim paperwork being complete AND funding availability in the Settlement and Judgment Reserve, Department fund or other source of legally available funds designated for payment of the claim. Although payment for properly filed claims is guaranteed (subject to any specific legislative restrictions) all payments are subject to appropriation and the exact timing of payments can not be guaranteed. CTR will verify if sufficient funds are available to pay a claim and the anticipated timing of payment ONLY when a claim has been placed in line for payment. See Section on [Processing Steps for Claim Payments](#)
- **Retirement Contributions or Retirement Creditable Service.** The State Board of Retirement has approved automated retirement contributions only for **back pay** employment awards which are processed through the state payroll system. Retirement contributions and creditable service can only be made when "salary" has actually been "earned" for time worked or time that would have been worked if the employee had not been suspended, terminated, subject to layoff etc. An employee cannot be awarded **back pay** amounts that exceed the number of days between the separation in service and the award or the number of hours being compensated for back pay (the employee cannot be paid more in **back pay** or earn more creditable service that the employee would have earned if employed during the time in dispute. Therefore, any amounts for contributions or creditable service that are intended to be sought that are not part of a **back pay** award MUST be negotiated separately directly with the State Retirement Board and approved in writing PRIOR to a final settlement judgment. In most cases, these adjustments and payments will NOT be processed through CTR but will be made directly by a Claimant to the State Retirement

Board. See [Back pay Retirement Contributions](#). Note that “**front pay**” which is meant to compensate for time that an employee would have worked in in the future is not considered back pay or salary payments that can be used to increase “creditable” service for retirement purposes and will be processed as a lump sum award.

- o **Note: The State Retirement Board requires that all back pay awards be supported by a spreadsheet outlining the number of days awarded and the back pay amounts for these days of service.**
- **Front Pay.** Front pay is a category of “lump sum” damages paid to an employee to compensate the individual for remuneration that would have been received after the settlement date or court award but for the employer’s alleged wrongful conduct or in a situation of extreme animosity between the employer and employee – which make it impracticable to return the employee in the position. Front pay is considered by the IRS to be “wages” but not “back pay”, therefore these amounts will not be subject to retirement contributions and can not be used for creditable service. See “[Lump Sum payments for Employees](#)” for additional information. Front pay is considered wages subject to employment taxes in the year paid, and are subject to the tax rates and FICA and FUTA wage bases in effect in the year paid.
- **Deferred Compensation Contributions.** Deferred Compensation contributions may be made by employees from settlements and judgments as a direct payment to the Deferred Comp Vendor (a contracted vendor through the Office of the State Treasurer) and NOT through the payroll system as a payroll deduction. The risk of “over contributions” for both the employee and the Commonwealth is too high. Since settlements and judgments are not regular payroll payments, the employee must take a copy of the settlement or judgment, demonstrate that the amount of the payment is “wages” subject to deferred comp (since the entire settlement may not be eligible for deferred comp.), have the Deferred Comp Vendor make the appropriate calculation to ensure that there are no over contributions, and then the employee issues a personal check or money order to the Deferred Comp Vendor. This is the only way to ensure that the proper amounts are taken from “eligible wages.” Payroll Directors should NOT be responsible for legal compliance of special payments and deferred comp contributions. The Deferred Comp Vendor by contract is responsible for tax and other Deferred Compensation Plan compliance, therefore, is in the best position to advise his/her clients (employee/Claimant) relative to contributions.
- **Pulled Checks.** Payroll payments are entered into the state payroll system (HR/CMS) and then processed through the state accounting system (MMARS). Checks or EFTs are issued through the Office of the State Treasurer (TRE) as manager of the Commonwealth’s bank accounts. Thousands of checks are issued, sorted and mailed weekly and locating a single check is a labor intensive and costly manual process. Therefore, Departments may not negotiate or agree (as part of a settlement or judgment) that a check will be “pulled” rather than mailed through the normal process unless there are exceptional extenuating circumstances. CTR processed payments will request pulls from the Treasurer’s Office **only** for exceptional circumstances. Checks processed through the state payroll system (HR/CMS) for FORMER employees or any employee NOT on direct deposit are usually delivered/picked up by the Department Payroll Department and can be hand delivered or mailed as instructed in the claim. Please note that Payees (including attorneys) who are set up in MMARS and current employees paid through HR/CMS using EFT-direct deposit will be paid through EFT-direct deposit unless this feature is turned off for the payment. Multiple payments to the same payee processed at the same time will be consolidated into the same check or EFT payment.
- **Current Employee Payments to Attorneys or 3rd Party.** Note that amounts for **back pay** or **lump sum** damages for a **current employee** must be processed through the state payroll system HR/CMS and CAN NOT be made payable jointly to an attorney or other 3rd party payee. HR/CMS can not segregate these amounts from “regular pay” and claim amounts will be paid in the same manner as the employee’s regular pay, less required withholdings. If attorneys fees are to be paid from these amounts, the attorney should negotiate with the claimant that a separate amount be identified as “attorneys fees” as part of the settlement or judgment, or should make arrangements that the claimant provide a check or electronic payment from the claimant’s personal bank account for the attorneys fees payable at the time the payroll payment will reach the claimant’s bank account. The Commonwealth is not responsible for ensuring that claimants honor fee agreements with attorneys or any other 3rd party.

- **Separate Cover Documents - Allocation of Damages of Payment Terms.** Cover sheets, letters, emails or faxes (not physically signed by a Claimant) MAY NOT be submitted with a breakdown or allocation of damages or payment processing requirements that do not appear in the claim documents. Payments are processed in accordance with the terms and how damages are identified in the Settlement or Judgment document and not by separate agreement, letter, or memorandum by the parties. Therefore, damages that are not separately identified by type of damage and amount in the Settlement or Judgment document or Release may not be split into multiple checks to the Claimant and attorney or a 3rd party at the time of payment. CTR will reject the claim and return it to the Agency Counsel for resolution.
 - o For example, a claim award of ***lump sum*** damages can not have a portion separately paid to the claimant's attorney if not so specified in the claim documents. All payment breakdown amounts and types of damages must appear in the Settlement/Judgment document or a separately execute Release. Cover letters are discouraged. All information required for processing a claim must be contained in the **Settlement/Judgment Authorization Form** which is certified by the Department CFO and Legal Counsel.
- **Intercept for Commonwealth owed Debts and Wage Garnishments.** All settlement and judgment payments are subject to [Intercept](#) for outstanding debts (tax liabilities, child support, student loans etc.) and no claim for failure to pay may be made against the Department or the Commonwealth for honoring intercept claims. Claims that are intercepted have already provided the Claimant with due process notice and an opportunity to dispute the debt or receive a hearing under 815 CMR 9:00. Employment claims processed through HR/CMS (state payroll system) will be subject to existing wage garnishments in HR/CMS (child support, tax liens, student loans etc.)
- **Confidentiality Provisions May be Unenforceable.** Departments are put on notice that confidentiality language mandating that a settlement or settlement terms be kept confidential may not be enforceable unless the claim or certain provisions in the claim are exempted from disclosure under statutory, personnel file or privacy exemptions under the Public Records Law. The Public Records Law, G.L. c. 4, §. 7, 26 (a) and (c) exempt records from disclosure that are statutorily prohibited from disclosure, are part of a personnel file or are of a highly personal nature. Tax Forms (W-4, W-9s) and settlement or judgment information are deemed highly personal and confidential and may not be released without the individual's written consent. Confidentiality provisions will not create protections that do not already exist under the Public Records Law or other statutory bar to disclosure.
- **Public Records Disclosure by the Office of the Comptroller.** Based upon a recent court decision, *Globe Newspaper Co., Inc. v. Executive Office of Administration and Finance, et. al.*, [Suffolk Superior Court Civil Action No. 11-01184-A](#), the name of a recipient payee of a settlement or judgment payment made from the settlement and judgment account is considered a public record. Page 36 of the decision outlines CTR's obligations under the court order to produce a list of payments made by CTR from the settlement and judgment account, but NOT the actual agreements or other details of any claim.
- **Disclosure of Name of Settlement/Judgment Recipient Payees.** CTR is required to release the department name, amount of a payment, and the name of the payee recipient, unless the Department has identified a statutory exemption for the payee recipient. As stated in the case, *"Further, neither OSC nor any agency subject to this ruling will be required to provide the name of any funds recipient the identity of whom is barred from disclosure by state or federal law."* Departments will now be required to identify a specific statutory exemption that bars the disclosure of a payee recipient name as part of the submission of a settlement or judgment for payment. Note that that general "personnel record" and "privacy" exemptions do not apply to the payee recipient name. In order for CTR to exempt a payee name, the Department must provide a specific statutory exemption barring the release of the name of a payee recipient
- All public records questions related to a particular claim(s) will be referred directly to the Department. As the record holder and Department responsible for the settlement or judgment, the Department is in the best position to responding to any public records request related to a settlement or judgment.
- **Class Action Special Considerations.** It is not uncommon for large class actions to hire a Claims Administrator to handle the litigation along with the Claimant Attorney. In private litigation, class actions often negotiate terms such as sending checks certified mail, paying the Claims

Administrator the entire settlement amount and letting them disburse checks, setting up escrow accounts to hold settlement funds until the settlement is completed, funding attorneys fees prior to the finalization of a settlement which are not actions that the Commonwealth can support. Therefore, the following are some limitations and protocols that should be communicated to Claims Administrators and Class Counsel when negotiating class actions:

- o CTR will have the sole discretion to determine, based upon the amounts payable to individual class members, whether individual class member payments will be entered into the state accounting system (MMARS) by individual, with a claimant vendor code based upon TIN and legal address, or whether a lump sum payment will be issued to the Claims Administrator and Class counsel for disbursement. This decision will be made based upon the class of individuals to be paid, the likelihood that payments issued through the MMARS system will actually reach recipients, whether the amounts support the ability to collect intercept of debts such as tax liabilities and outstanding child support payments, and intercept fees and the most cost effective use of taxpayer funds to fulfill the terms of a judgment or settlement and any associated tax liabilities. CTR may screen class member TINs for potential intercepts and may identify a subset of class members whose payments will be processed by CTR to enable intercept, with the remainder of class members paid through disbursements made by the Claims Administrator and Class Counsel.
- o All class members will be required to provide proof of legal name, legal address and Tax Identification Number (TIN-SSN) or federal employer identification number (FEIN) through submission of an IRS Form W-9 or **a substitute W-9, or in the alternative a Claim form that contains the same information as the W-9 and specific language certifying** that the legal name, legal address and Tax Identification Number matches what they have already filed with the IRS and the Department of Revenue (DOR) and is accurate under the pains and penalties of perjury.
- o If the payments are made through MMARS to individual class members, the class members will receive a system generated 1099-MISC (box 3) or other appropriate tax reporting form to the legal name, legal address and TIN/FEIN of the class member's Vendor Code based for payments issued under tax reportable object codes. In the event CTR determines that a lump sum check will be issued to the Claims Administrator and Class Counsel for disbursement to class members, the Claims Administrator and Class Counsel will be responsible for any tax reporting to class members in accordance with tax laws.
- o CTR has no obligation to inform either the Claims Administrator or Class Counsel when there are sufficient funds for payment and has no authority to accommodate specific time periods or demands in conflict with this Policy. Class action payments are treated the same as any other settlement or judgment payment and will not be paid ahead of any other claim already in line for payment. Documentation must be filed complete, and claims are put in line for payment at that time and paid in the order the claims are in line for payment. Absent exceptional circumstances the Commonwealth does not hold or reserve funds for any claim without special legislation.
- o If Funding in the S/J Reserve is depleted and only a portion of the total Claimant payments can be processed, the claims will be paid based upon the order provided in the approved spreadsheet of class members submitted for payment. Normally the class members are paid in alphabetical order. Claimant payments will be made prior to any fees for the Claims Administrator or Class Counsel, unless the funding for class members is being made in a lump sum amount to the Claims Administrator and Class Counsel for disbursement. In this situation, if individual class member payments are not anticipated for immediate disbursement, the Claims Administrator or Class Counsel payments may be made ahead of the lump sum payment.
- o Class actions should contain language that the Commonwealth is released from any residual or remaining amounts that are not paid out under a settlement. If class members cannot be identified, or the full amount of the award cannot be disbursed, language should not be negotiated that remaining funds will be paid to the Claims Administrator for administrative costs or used for other purposes. There should be no windfall of taxpayer funds used for other purposes unless so ordered by a court under a judgment.
- o Claims Administrators must prepare a settlement distribution list in the form of a spreadsheet which will contain the legal name, legal address, mailing address (if different),

and TIN/EINs of the participating class members as well as the Distribution Amount for each Participating Class Member ("Distribution Spreadsheet"). If CTR will be making the individual payments, the Claims Administrator shall send the Distribution Spreadsheet and COPIES of all of the Substitute W-9 forms or claim forms once the settlement has been finalized and executed by the parties, and has received any court approval, and after the time for any appeals to the Claims Administrator of denied claims has expired.

- o The accuracy of the Claim Forms is critical and Claimants must be informed that any discrepancies in what is contained in the Claim Form from what the IRS or DOR already have on file for tax reporting information may result in an unnecessary delay in payment or misrouting of the payment. If individual class member payments are being processed by CTR, the Commonwealth will be released of any responsibility for mistakes in payment information once the Class Counsel certifies the payment information for class members including deceased class member representatives.
- o If CTR is processing payments, Claims Administrators may request that checks be issued and pulled in a batch and picked up by the Claims Administrator, at which time the Claims Administrator will assume the full responsibility for disbursement of the checks to Class participants.
- o Checks issued by the Commonwealth may be rejected at certain banks if not cashed within 60 days, so Claim Forms should contain notice that checks must be cashed immediately or may not be honored after 60 days. The Claims Administrator or Class Counsel will be responsible for any check re-issues requested through CTR. Claimants may not directly request a check re-issue through CTR.
- o If CTR has issued payments and funds have been intercepted for outstanding debts (for taxes, child support etc.) the Claimant will get notice on the check stub with a contact for the Department that intercepted the amount. Claimants have received due process of intercepts prior to the claim being processed and cannot challenge the intercept through CTR but must contact the Department that issued the intercept. For child support payments, intercepts are statutorily mandated from any payments made to a class member.
- o Checks once issued by the Commonwealth may be not be re-issued with different names, addresses or tax information without being cancelled and the vendor set up process beginning again. This process may take several weeks and if funding has lapsed due to the end of the fiscal year, funding may not be available until the next budget vehicle and additional delays may occur. Therefore, if CTR is issuing individual class member payments, it is critical that accurate information be submitted on the Claim Form to avoid unnecessary delays.
- o At the conclusion of processing, CTR may run reports on what checks have been cashed or remain un-cashed at any given time. All funding once issued is deducted from the S&J Reserve and remains with TRE until the check is cashed. Checks not presented for payment within one year from the original date of issue (cashed) will be subject to M.G.L. c. 29, § 32. The funding for the check is transferred to the Abandoned Property Fund and must be claimed through that process through TRE.
- o Any checks returned to CTR un-cashed will be forwarded to Class Counsel or the Claims Administrator who will be responsible for attempting to locate the affected class members. CTR will not assume any responsibility for attempting to locate class members for un-cashed or undeliverable checks.
- o **Deceased Class Members.** Representatives for a deceased class member may file a Claim Form on behalf of the Class Member's estate, or may return an un-cashed check to the Claims Administrator if the Class Member died before cashing the check. The representative must provide to the Claims Administrator with documentation that an estate has been established in accordance with the law and that he or she is the duly appointed administrator or executor, including a W-9 Form or substitute W-9. The Claims Administrator will have full responsibility to verify that the representative is an eligible and legally authorized recipient of the funds. In the event there is a dispute or challenge to the representative's receipt of the funds, the Claims Administrator will be solely responsible for resolving this issue. If a Participating Class Member dies after the Claims Administrator

and Class Counsel have certified payment information but before cashing the payment, the Claim Administrator or Class Counsel will be responsible for working with CTR to re-issue the check to the appropriate representative.

- o CTR is able upon request to provide a final report outlining the payments that have been made to individual class members.

Tax Reporting of Settlements and Judgments - Overview

With limited exceptions, most settlement and judgment payments made by the Commonwealth are tax reportable to Claimants and other payees. Please see the IRS Guidance issued for audit standards at: <http://www.irs.gov/businesses/small/article/0,,id=248471,00.html> or <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf>.

The tax treatment of a settlement or judgment is determined by the type of claim filed and the type of damages awarded as part of the resolution of the claim. Claim documents and payment requirements cannot be drafted to attempt to avoid tax consequences or to waive or shift tax liabilities from the Claimant to another party. Settlement agreement or judgment language identifying the form that will be used for tax reporting purposes or the tax treatment of an amount will not be binding upon the Commonwealth if contrary to state or federal tax reporting or withholding requirements as outlined in this policy.

The State Payroll System and the State Accounting System are programmed to make automated tax withholdings and tax reporting based upon the earnings or object codes selected for a payment and the tax identification number of the payee being paid. Additional tax reporting will be made for a Claimant, Attorney or 3rd party listed as a joint payee on a check.

NOTE: STATE FINANCE LAW AND TAX LAW VIOLATION

Any Department Head or designee who knowingly violates state finance law or authorizes or directs another officer or employee to violate any provision of G.L. c. 29, or any rule or regulation promulgated there under, or any other provision of law relating to the incurring of liability or expenditure of public funds law shall be punished by a fine of \$1,000 or imprisonment for one year, or both.

See G.L. c. 29, § 66. Please be advised that Departments may NOT “re-characterize” or make a payment for a settlement or judgment using a different process, different object or earnings codes, or drafting terms in an effort to avoid tax reporting or tax liabilities or to shift a tax reporting or tax liability to a 3rd party.

Tax reporting for a Class action payment which does not identify individual Claimant payments, or does not identify a percentage or amount per claimant, will be made solely to the attorney or 3rd party payee receiving payment on behalf of a class. This option is rare and is primarily used for “attorneys fees” made on behalf of a class. Claims in which amounts in excess of \$600 will be awarded to individuals normally require tax reporting.

Types of Damages and Tax Reporting and Withholding Responsibilities.

For the purposes of performing tax reporting and withholding responsibilities, the Commonwealth classifies damages in the following categories:

1. Back pay or salary replacement (Current or Former Employees only)
2. Lump sum or Non-specified damages (emotional distress, overtime, front pay, compensatory, consequential, civil rights, or other all-inclusive or non-specified damages to resolve a claim)
3. Attorney fees and costs (awarded or negotiated)
4. Interest on damages or Attorney fees (G.L. c. 631, § 61 or other statutory fee)
5. Punitive damages
6. Non-Tax Reportable Damages:
 - a. Reimbursement for substantiated actual medical expenses for emotional distress

- b. M.G.L. c. 258 tort personal injury or property damage (subject to IRS definitions)
- c. Reimbursements (subject to IRS definitions). Reimbursements types are limited.
- d. Indemnification (reimbursement for defense costs or attorney payments authorized under M.G.L. c.258)

The following sections outline how each of these damage payments will be processed by the Commonwealth for tax withholding and reporting purposes.

Employment Related Claims - General Information

An Employment related claim includes any claim, grievance, law suit or any other dispute filed against a Department by a current or former employee which arose out of the employment relationship. Employment related claims that require processing through the payroll system will be reviewed by CTR Legal and instructions will be emailed to the Department CFO, Department Payroll Director and the Payroll Contact listed in the **Settlement/Judgment Payment Authorization Form**. Departments must ensure that key contacts for Payroll and Chief Fiscal Officer are kept up to date.

- o Employment claims for **lump sum** and **back pay** damages must be processed through the payroll system and will require that a former employee be rehired into the payroll system PRIOR to submitting the paperwork to CTR for processing. **Please note** that the rehiring of an employee for payment purposes creates **NO** employment status for the former employee and is completed only to facilitate payroll payments that must be processed through the payroll system to accurately process tax withholdings and tax reporting on a W-2 Form.
- o For punitive damages, interest and reimbursements paid solely to the Claimant, payment through HR/CMS is preferred rather than MMARS since MMARS VCUST entries are public information and payment information can not be maintained as confidential.
- o Payments that do not require withholdings that are to be made jointly to attorney or 3rd party can be processed through HR/CMS or MMARS as deemed appropriate by CTR.
- o Employment-related **back pay** and **lump sum** payroll claims will be subject to tax withholdings prior to payment.
- o Any portion of a claim that represents "income" that is not excludable must be reported by the Commonwealth. For example, **lump sums**, wages, punitive damages, Attorney fees, costs or interest awarded under a tort or non-tort settlement or judgment are tax reportable to the Claimant. Each Claimant shall receive either a W-2 or a 1099-MISC for all or a portion of an award subject to tax reporting.
- o Pursuant to [Internal Revenue Code § 61](#) (Gross Income Defined) and [Internal Revenue Code § 104](#) (Compensation for injuries or sickness), all settlements and judgments (including punitive, compensatory or liquidated damages) for "nonphysical injuries or physical sickness" are tax reportable by the Commonwealth. Therefore, tort claims for non-physical injuries or sickness, are tax reportable (1099-Misc Box 3) to non-employee Claimants.

With very limited exceptions, **all employment settlements and judgments for current or former state employees are tax reportable**, and must be processed through the state payroll system to ensure that the appropriate tax, retirement and payroll deductions, withholdings and tax reporting are made. Pursuant to [Internal Revenue Code Section 3402\(a\)\(1\)](#), the Commonwealth is required to withhold income and employment taxes on employee wages (for both current and former employees) awarded in settlements and judgments, even if payment of the settlement or judgment is to be made payable jointly to the Claimant and Claimant's attorney.

Note: *Damages recovered from an employment-related dispute generally are not recoveries for a personal physical injury. Thus, employment-related judgment/settlement amounts will generally be included in the employee's gross income. Therefore, the most difficult questions usually are whether the amounts are wages for employment tax purposes, and the proper reporting of the amount (Form 1099 or Form W-2, and reporting of attorneys' fees on Form 1099). See: <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf>*

Emotional Distress is Not Considered "Personal Injury or Sickness."

The IRS tax and tax reporting exemptions for a tort claim for physical injuries or sickness would apply only to tort claims for physical injuries or sickness brought under G.L. c. 258 by **non-employees**. Employee claims (by either current or former employees) for employer-caused physical injuries are not governed by G.L. c. 258 since employee work-related physical injuries are compensable under workers compensation statutes (see [G.L. c. 152](#); [G.L. c. 23E](#); and [G.L. c. 30, §. 58](#)).

Emotional distress is not considered a “personal injury” compensable under workers’ compensation. (See [G.L. c. 152, § 29](#) which states in part that, “[n]o mental or emotional disability arising principally out of a bona fide, personnel action including a transfer, promotion, demotion, or termination except such action which is the intentional infliction of emotional harm shall be deemed to be a personal injury within the meaning of this chapter.” This state law treatment of emotional distress as a non-physical injury or physical sickness is consistent with [Internal Revenue Code § 104\(a\)\(5\)](#).)

- Claims for emotional distress, including physical symptoms such as insomnia, headaches, loss of consortium, depression, irritability and stomach disorders, are **not** considered received for physical injuries and are tax reportable to the Claimant. (See [Internal Revenue Code § 104\(a\)\(5\)](#) providing that for purpose of § 104(a)(2) “emotional distress shall not be treated as a physical injury or physical sickness.”) Therefore, a settlement for an emotional distress claim arising from a civil rights or personnel action is tax reportable, since the emotional distress did not arise directly from a personal injury or sickness. In the IRS guidance, the IRS provides:

As a result of the above 1996 changes to IRC section 104(a)(2), a taxpayer receiving lawsuit proceeds from a non-physical injury claim cannot exclude any amount for payment to compensate for an intangible emotional distress value. The taxpayer can only exclude an amount for actual out of pocket medical costs. This exclusion would further depend upon whether the taxpayer had previously deducted those medical expenses on his or her tax return. See IRC sections 111 and 213.

Employee claims for physical injuries caused by an employer outside the scope of employment or as the result of an intentional tort would be not payable by the Commonwealth, but rather a personal cause of action against the individual, outside the scope of the individual’s employment, outside the scope of G.L. c. 258 (see [G.L. c. 258, §10.](#))

Definition of “Wages” Subject To Withholdings Prior to Payment.

For the purposes of FICA (Social Security and Medicare taxes) under [Internal Revenue Code Section 3121\(a\)](#) “wages” consist of “all remuneration for employment.” Under [Internal Revenue Code Section 3121\(b\)](#) “employment” is defined as “any service, of whatever nature, performed by an employee for the person employing him.” The name by which remuneration for employment, the basis for remuneration (hourly, percentage, etc.) or the medium of payment is immaterial to the determination of whether remuneration constitutes wages for the purposes of employment taxes. See 26 CFR ch. 1 § 31.3401(a)-1.

For the purposes of federal income tax reporting and withholdings, [Internal Revenue Code § 3401\(c\)](#) defines an “employee” as, an officer, employee, or elected official of the United States, **a State**, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of these entities. Under [Internal Revenue Code § 3401\(a\)](#) “wages” consist of “all remuneration for services performed by an employee for his employer.” The name by which remuneration for services is designated, the basis for remuneration (hourly, percentage, etc.) or the medium of payment is immaterial to the determination of whether remuneration constitutes wages for the purposes of IRC § 3401. See 26 CFR § 31.3401(a) at: <http://law.justia.com/cfr/title26/26-15.0.1.1.1.5.15.29.html>. See also: <http://www.irs.gov/pub/irs-drop/rr-06-18.pdf>.

The IRS interprets remuneration for employment broadly as any compensation arising out of the employment relationship, including **back pay**, lost wages, future wages, unpaid life, health or disability premiums, emotional distress damages, or other payment as “wages.” Compensation arising out of the employment relationship includes not only payment for actual “services” performed during the period of employment, but any payments, both back wages and future wages, that otherwise would have been paid regardless of whether the employee worked during the time period in question. See *Gerbac v. United States* (1999); *Social Security Board v. Nierotko*, 327 U.S. 358 (1946) <http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=us&vol=327&invol=358>, and *Hemelt v. United States*, 122 F.3d 204, 209-211 (4th Cir. 1997). See IRS Publication 15 for penalties associated with failure to withhold federal taxes. <http://www.irs.gov/publications/p15/index.html>.

For the purposes of Massachusetts state income tax reporting and withholding, chapter 62B adopts the federal definitions of “employer” found in IRC section 3401(d), “employee” found in IRC section 3401(c), and the definition of “wages” found in IRC section 3401(a). See [G.L. c. 62B, § 1](#). See also [G.L. c. 62B, § 7](#) for penalties for failure to withhold taxes.

When determining whether remuneration is for employment and therefore considered “wages” several questions are asked:

1. Was the Claimant an employee of the Department at the time of the alleged wrongdoing by the Department?
2. Did the settlement or judgment arise out of the Claimant’s current or previous employment relationship with the Department?

If the answer to these questions is “Yes,” then with limited exceptions, damages awarded will be processed as “wages” and subject tax reporting and withholding for state and federal income taxes and the Medicare portion of FICA (unless the employee is exempt). Note: The Commonwealth does not withhold Social Security payments because employees have state retirement or Optional retirement (OBRA) deductions made from wages in lieu of Social Security.

EXAMPLE 1. A job applicant’s age discrimination claim for a failure to be hired would not qualify as remuneration for employment or “wages” since the applicant was not an employee of the Department, and the settlement or judgment did not arise out of a current or previous employment relationship with the Department. Any resulting settlement and judgment would be a non-employment related claim payable through the state accounting system and requiring a 1099-MISC (Box 3) to the Claimant.

EXAMPLE 2. A current or former employee’s discrimination claim for termination, failure to promote, or failure to be hired into a different position would qualify as remuneration for employment since the applicant employee was an employee at the time of alleged wrongdoing and the settlement or judgment arose out of the employment relationship with the Department. The Department would be required to report the full amount of the award as gross income and the portion of the award not specified as Attorney fees, costs, punitive damages or interest would be considered “wages” subject to tax withholding, retirement and other state and federal legal obligations.

EMPLOYMENT CLAIM PROCESSING REQUIREMENTS

1) *Back pay or salary replacement (Current or Former Employees only)*

In order to be considered “**back pay**” the settlement or judgment language must identify a specific amount as “**back pay**” (lost wages, salary replacement etc.). **Back pay** must reflect a calculation based upon a number of days or hours, or incremental salary increases of salary being paid LESS any unemployment payments, workers compensation, disability payments or other salary paid from other sources if the employee was off the payroll during the period being compensated for back pay. If other damages are included as part of a **back pay** award amount (such as overtime, front pay, emotional distress) the entire amount must be treated as a “**lump sum**” award and not **back pay**.

Back pay Tax Withholdings.

Back pay is considered “wages” and will be processed through the payroll system and subject to tax reporting and withholdings, including state and federal income tax, Medicare and retirement deductions prior to payment to the Claimant or Claimant’s attorney.

Claimants can not dictate how the taxes will be withheld or the amounts and the Commonwealth can not by settlement or judgment agree to waive its obligation to make required tax withholdings. **Back pay** is automatically calculated by the payroll system as Supplemental with flat tax withholding amounts. Personal exemptions are not calculated since this would require an annualized calculation that could result in higher taxes being withheld for many claims and makes it difficult to accurately calculate the final payment amounts without processing the actual claim through HR/CMS. Withholdings are made in the following order:

1. **Retirement contributions.** Retirement deductions are calculated at the rates entered into the Pension Plan for the employee.
2. **State income tax (*Back pay* less retirement) * 5.25%**

3. **Federal income tax** (**Back pay** less retirement) * 25%
4. **Medicare tax** (1.45% * **Back pay** unless Employee exempt). Department needs to check if the employee was subject to Medicare tax on the last payroll period paid. If exempt, uncheck Medicare box so that Medicare is not taken (only if employee was hired prior to April 1, 1986 with no break in service since).
5. **Existing automated wage garnishments for child support liens, tax liens, student loans etc.** Departments and Managing Attorneys should request certification of any outstanding debts to the Commonwealth. Outstanding child support or tax liens should be identified in addition to any wage garnishments already in place. Debt repayment may not be considered in award calculations to increase amounts of claims to offset the debts.
6. **Deductions for Additional Earned Income/Wages during Separation.** Amounts of any income earned from other sources during any separation in employment for which back pay is being awarded (such as private wages, unemployment benefits or retirement benefits) must be deducted from the final award paid so that the employee is not receiving more wages than the employee would have received during the separation from employment. Retirement wages paid during separation must be repaid to the Retirement Board (to make the employee's account whole from any back pay award, from post-tax amounts since the employee may be paid more retirement than the employee would have been paid if the separation from employment had not occurred. Unemployment earnings will be paid back to the State Department of Unemployment Assistance on behalf of the employee from any back pay award, from post-tax amounts. Repayments to the State Retirement Board and the State Department of Unemployment Assistance are made from post-tax back pay amounts in order to provide the full retirement credit and deductions and ensure appropriate tax withholdings. Even though the retirement payments and unemployment payments were paid with taxes deducted, the IRS does not consider the back pay award to be a reimbursement but a make whole payment, which is subject to withholdings. It may appear that the employee is being taxed twice for the same wages, but the IRS considers the payments to be two separate wage events subject to tax at the time of payment. Employees may always claim an overpayment of taxes when filing their tax returns.

Retirement contributions and creditable service. Retirement deductions, creditable service and retirement terms are not subject to negotiation as part of a settlement or judgment and are not binding upon the Commonwealth without written approval from the State Retirement Board. Retirement deductions for **back pay** awards are automatically calculated and deducted by the payroll system and transmitted to the State Retirement Board on behalf of an employee. A **lump sum** representing both **back pay** and other damages (such as emotional distress) which does not specify an exact amount of salary or **back pay** will not have retirement deductions withheld. If the employee wants retirement contributions made from these types of payments, the employee must submit a copy of the settlement to the State Retirement Board directly and request approval of a contribution amount. If so approved, the contribution will be payable directly by the employee to the State Retirement Board, and not by CTR.

- The State Retirement Board will not honor separately negotiated retirement contributions as part of a Settlement Agreement unless approved in advance by the State Retirement Board and paid separately by the Department to the Board.
- CTR cannot process retirement contributions from the Settlement & Judgment Reserve except for **back pay** awards and will not honor separately negotiated contributions without prior written approval directly from the State Retirement Board. All retirement contributions for amounts other than the automated contributions for **back pay** awards must be paid directly by the Department or the employee. Retirement contributions are an "employee" responsibility and Departments may NOT negotiate or use appropriated dollars to make a separate payment to the State Retirement Board. Departments MAY NOT negotiate claims that have retirement contributions being paid to the State Retirement Board unless the State Retirement Board has been included in the process and has approved the agreement. Note that Employer-paid retirement contributions may have gross income tax implications for the Claimant and the Claimant will be responsible for reporting any amounts and payment of any tax obligations at the time of payment.

- It is the State Retirement Board policy that the determination of whether a settlement or judgment payment is subject to retirement is based upon whether or not the payment should have been included as “regular compensation” at the time the employee “should have been paid,” and if that payment at the time would have been subject to retirement. The premise being, that the employee was not compensated for the amount for which they were entitled. Therefore, if the claim amount reflects what the employee “should have been paid” and the earning code that would have been used at that time was subject to retirement, then the **back pay** payment would also be subject to retirement. If the payment is for other types of compensation (to make the person whole) and is not reimbursement for amounts that “should have been paid” under an earnings code subject to retirement, then the payment would be a compensatory **lump sum** payment and NOT entitled to retirement deductions.

Back Pay awarded after Retirement. In the event a former employee receives a back pay award after the employee has retired and begun receiving retirement benefits, the State Retirement Board requires the employee to reduce the final amount paid by the retirement benefits already received, from the back pay award, post tax. For tax purposes, the IRS has determined that back pay awards, even though making the employee whole for amounts that would have been paid, are wages subject to withholdings at the time of payment.

Verify Pension Plan Set Up. Payroll Directors should make sure that the employee’s Pension Plan is set up with the correct Retirement % to be taken for the employee.

Deferred Compensation and Make-up Retirement Deductions. Payroll Directors should be instructed to **TURN OFF** any additional pension plan deductions such as makeup retirement or deferred compensation for this pay period, since these deductions will be taken against **back pay** amounts if not turned off. This will result in no deductions for either make-up or deferred comp on any regular salary or other wages paid on this pay period to a current employee, however, most claims do not authorize these amounts to be deducted from the claim and the Commonwealth is making a policy determination that these amounts should not be deducted. In addition, if the claim amount is significant, the deferred comp or other deductions may result in deposits exceeding the legal limits for the employee, creating a tax violation that presents problems both for the employee and the payroll department to correct.

2) **Lump sum Awards.**

Lump sum awards include any award that does not identify a specific breakdown of damages (all-inclusive awards) or awards for emotional distress, overtime, front pay, compensatory, consequential or any other undesignated damages to settle a claim.

Tax Reporting for Non-Employee Lump sum Awards

Lump sum awards for non-employees are paid through the state accounting system MMARS and reported to the Claimant on a 1099-MISC (Box 3) unless the amount is less than \$600 or the Claimant is a corporation. If the payment is made solely or jointly to Claimant’s Attorney or a 3rd party, additional reporting will be required for these additional payees. Negotiating that payments be made solely to the Claimant’s Attorney or a 3rd party does not shift the tax or tax reporting responsibilities to the Attorney or 3rd party but merely adds additional reporting responsibilities for the Commonwealth.

Tax Reporting and Withholdings for Employee Lump sum Awards (Compensatory Damages).

Lump sum awards for employees are paid through the State Payroll system (HR/CMS). Claimants cannot dictate how the taxes will be reported or withheld. The Commonwealth can not by settlement or judgment agree to waive its obligation to make required tax withholdings. **Lump sum** payments must be paid through the payroll system, and withholdings are automatically calculated by the payroll system as Supplemental with flat tax withholding amounts. Personal exemptions are not calculated since this would require an annualized calculation that could result in higher taxes being withheld for many claims. **Lump sum** awards are reported to the employee on a W-2, even if the check is ultimately issued to an attorney or 3rd party. Negotiating that payments be made solely to the Claimant’s Attorney or a 3rd party (payments to former employees only) does not shift the tax or tax reporting responsibilities to the Attorney or 3rd, but merely adds additional reporting responsibilities for the Commonwealth. Withholdings are made as follows:

1. **State income tax** (5.25% of Amount)
2. **Federal income tax** (25% of Amount)

3. **Medicare tax** (1.45% of Amount unless Employee exempt). Department needs to check if the employee was subject to Medicare tax on the last payroll period paid. If exempt, uncheck Medicare box so that Medicare is not taken (only if employee was hired prior to April 1, 1986 with no break in service since).
4. **Existing automated wage garnishments for child support, tax liens, student loans etc.** Departments and Managing Attorneys should request certification of any outstanding debts to the Commonwealth. Outstanding child support or tax liens should be identified in addition to any wage garnishments already in place. Debt repayment may not be considered in award calculations to increase amounts of claims to offset the debts.

NO Retirement contributions are made.

Although some **lump sum** awards may not be clearly categorized as “wages”, these amounts are remuneration related to employment and ultimately may be deemed by the IRS or DOR to be “wages” that should be subject to withholdings. While employers generally report compensatory damages on a 1099-MISC, the IRS has become increasingly concerned that parties are not properly characterizing the damages in settlements in an effort to avoid or defer the tax liabilities for a Claimant payment. As these amounts are clearly “income”, and are remuneration related to employment, these amounts are taxable. Attempts to defer the payment of taxes until a tax forms are filed are ill-advised and may subject the claimants to tax penalties for failure to file quarterly estimated taxes.

Further, the IRS states, “*In determining the status of settlement payments, keep in mind the broad definitions of “wages.” See Social Security Board v. Nierotko, 327 U.S. 358 (1946); see also Hemelt v. United States, 122 F.3d 204, 209-11 (4th Cir. 1997). See p. 18 <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf>*”

- The IRS ruled in an emotional distress employment claim which has been reported “as negotiated” on a 1099-MISC, was in fact **not properly allocated to back pay vs. lump sum** (emotional distress) and that the **entire amount should have been treated as “wages”** subject to tax withholdings. See IRS National Office Technical Advice Memorandum #200244004, 11/01/2002, TAM-130245-01 <http://www.irs.gov/pub/irs-wd/0244004.pdf>.

“Under these circumstances, we see no factual basis for allocating two-thirds of the total amount paid to Employee B to emotional distress. In our view, this is a situation where the allocation does not reflect the economic substance of the settlement and does not reflect the realities of the underlying claim. Moreover, we note that the parties were not adversarial with respect to the allocation, as both parties would benefit from characterizing the bulk of the settlement to emotional distress and thereby avoiding liability for employment taxes that would be owed if the payments were properly characterized as back wages. Accordingly, we conclude that the proper characterization of one hundred percent of the settlement payments made to Employee B is wages subject to employment taxes.”

See also: Public Letter Ruling PLR - 101732-00, #200041022, 10/13/2000 Index # 104.03-00, <http://www.irs.gov/pub/irs-wd/0041022.pdf>

“Since the nature of recovery directly affects the taxing of settlement and judgment payments, employers must specifically allocate each dollar of recovery to its respective category of damages in either its settlement agreement or court order. Failure to allocate damages into categories will allow the IRS, in its discretion, to allocate damages or to treat the entire payment as back wages, Rev. Rul. 80-364. This reallocation or treatment by the IRS may result in additional employer liability, employee's portion of FICA for the increased amount, plus penalties and interest, as well as employer liability for failure to withhold taxes, plus penalties and interest.” See <http://www.ohr.sc.gov/OHR/employer/OHR-settlement-faqs.phtml>

Note that when Claimant’s Counsel and Claimants are provided with this more conservative approach to withholding on lump sum payments, the Commonwealth is often presented with offers for inclusion of language that the Claimant will “indemnify” the Commonwealth in the event the Commonwealth suffers damages for improper allocation of damages. While this may “appear” to be a reasonable solution, the Commonwealth as payor is subject to “treble” damages, penalties and interest “**in addition to**” any damages levied against the Claimant for the same failure to properly pay withholdings and back taxes, penalties and interest. The likelihood of any Claimant having this level of funding to reimburse the Commonwealth is

minimal and therefore does not reduce the risks to the Commonwealth **OR** equally important for the Claimant, for significant unfunded taxes, penalties and interest.

In the event of an IRS audit of either the Commonwealth or an individual taxpayer, the IRS may within 3 years of a settlement or judgment payment determine that a settlement or judgment was “improperly allocated” and should have been treated as wages subject to withholdings at the time of payment. **BOTH** the Commonwealth AND the Claimant would be subject to penalties, interest, Medicare taxes and any back taxes if insufficient taxes have been paid. This costly and financially devastating result for both the Commonwealth and the Claimant is easily avoided by taking a more proactive approach to withholdings at the time of payment for ANY amounts that might be considered wages at a later date. Note that these damages ARE generally subject to taxes, therefore, it is not a situation of whether taxes are to be paid, but “when.” See **Potential Claimant Penalties for tax returns that are not filed or unpaid taxes** section below.

As an expert in this tax law area has opined:

“In response to a statement that the employer could be burned by failing to withhold any taxes from the settlement payment, the employee or her counsel will often offer to provide a tax indemnity to the employer. Under the terms of such an indemnity, the employee promises to reimburse any costs that the employer incurs as a result of not withholding taxes. This indemnity is common and may make the employer feel somewhat more comfortable — but it is worth asking whether the employee will have the money to indemnify the employer when that time comes. After all, the need for an indemnity would only arise if the employee failed to pay her taxes. If the employee does not have the money to pay taxes herself, it is unclear that she will have the money to abide by the indemnity agreement.” See: <http://www.jamsadr.com/files/Uploads/Documents/Articles/Grossman-Tax-Issues-Employment-Law-2011-06-01.pdf>

- The IRS states, “Be aware that the label placed on settlement payments by the plaintiff and the defendant does not necessarily control the employment tax treatment of such payments. See Treas. Reg. §§ 31.3121(a)-1(c), 31.3306(b)-1(c), and 31.3401(a)-1(a)(2) (the name by which remuneration for employment is designated is “immaterial”). Because both parties generally benefit by classifying payments as non-wage payments, the specific portion of a settlement agreement allocating payments to non-wage payments is generally not based on an arm’s length negotiation between adverse parties.” See <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf>

As the State Tax Clearinghouse for Commonwealth payments, CTR is ultimately accountable to the Internal Revenue Service (IRS) and the Department of Revenue (DOR) for the appropriate tax reporting and withholding on employment damage awards. CTR does not control the manner in which awards are allocated by departments and Claimants, or courts and other administrative authorities with respect to breakdowns for **back pay, lump sum**, emotional distress, Attorney fees, etc. As a result, CTR cannot guarantee that awards will be considered “reasonably allocated” for tax purposes. Therefore, CTR has determined that **all lump sum** employment awards (including awards for emotional distress or other compensatory damages) will be processed as “wages” through the payroll system and subject to state and federal income tax withholdings, and Medicare tax (unless the employee is exempt) prior to payment to the Claimant or Claimant’s attorney.

This treatment, although conservative, does not change the ultimate taxability of the payment to the Claimant, while ensuring the Commonwealth is properly reporting and meeting its tax withholding obligations. In addition, the Commonwealth has found that this treatment is considered “Claimant-friendly” by ensuring that most (if not all) of a Claimant’s tax responsibilities for these amounts are fulfilled at the time of payment, rather than deferring tax obligations until the end of the tax year when the Claimant is then subject to tax liabilities related to these awards, including penalties for failure to pay “**estimated tax payments**” in the tax quarter in which the payment is received. See <http://www.irs.gov/pub/irs-pdf/p4345.pdf> in which the IRS States: “Some settlement recipients may need to make estimated tax payments if they expect his/her tax to be \$1,000 or more after subtracting credits & withholding. Information on estimated taxes can be found in IRS Publication 505, Tax Withholding and Estimated Tax, and in Form 1040-ES, Estimated Tax for Individuals.”

- The IRS states, “As a general rule, dismissal pay, severance pay, or other payments for involuntary termination of employment are wages for federal employment tax purposes.” See Rev. Rul. 90-72; Rev. Rul. 73-166; see also *Abrahamsen v. United States*, 44 Fed. Cl. 260

(1999), *aff'd*, 228 F.3d 1360 (Fed. Cir. 2000). See p. 20 <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf>

- The IRS states, “The Service’s position is that “front pay,” which is pay awarded to the employee for future services (that is, generally service from the date of the settlement going forward) the employee would have performed but for the illegal actions of the employer, **is also wages** for federal employment tax purposes. Some courts have disagreed with this position. However, Nierotko supports the Service’s position. In addition, Service’s position is that settlements including cash payments made to employees by employers in lieu of providing benefits under employer plans (for example, paid in lieu of health insurance or qualified pension plan benefits) are also wages for federal employment tax purposes, because no exception from wages applies. Back pay and front pay are wages subject to employment taxes in the year paid, and are subject to the tax rates and FICA and FUTA wage bases in effect in the year paid. *U.S. v. Cleveland Indians Baseball, Co* 532 U.S. 200 (2001). See p. 19 <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf>
- **CURRENT EMPLOYEES ONLY:** If claimant is a current employee, the payee and payment address can not be changed in the payroll system. Payments made for **Back pay** or **Lump sum** damages that require tax withholdings can not be segregated from the employee’s regular pay, nor can these payments be issued to a 3rd party, or jointly issued to an attorney. Payments will be included along with the employee’s regular pay. If payment has been requested to be issued or made payable in any other manner than directly to the employee, the Claimant must be notified (through Claimant’s attorney if applicable) of this system limitation, and that the payment will be processed through the payroll system (less required tax deductions) and issued and made payable directly to the employee.
- **Civil Rights Claims - With claim of Personal injury or personal sickness.** Some civil rights claims identify a tort-like damage with resulting personal injury or sickness which is filed in state or federal court outside the tort claim act under c. 258. Personal injury and property damage claims awarded under G.L. c. 258 are automatically exempted from tax reporting and are exempt from taxes. Civil rights claims with a claim of personal injury or personal sickness are not automatically exempted from tax reporting and are not automatically exempt from taxes. Therefore, since each case is treated on a case-by-case basis, the Commonwealth will withhold on **civil rights employment claims** and report these amounts as wages on a W-2 prior to payment. The claimant may claim a refund under IRC s. 104 when filing a tax return. Given the likelihood that the IRS may not agree that the type of civil rights damages support a IRC s. 104 exemption, the Commonwealth reserves the right to take the withholdings at the time of payment.

3) Attorney Fees And Costs

Amounts specifically awarded separately as “attorney fees” or “costs” are usually paid directly to Claimant’s Attorney through MMARS and are tax reportable to the attorney under a 1099-MISC (Box 14). If damages are also being made payable jointly to the Attorney and Claimant, these amounts may be consolidated into a single check to the Attorney. See [Payment Options](#).

Attorneys fees will be tax reportable to the Claimant on a 1099-MISC (Box 3). These amounts are not considered “wages” and will not be subject to withholdings prior to payment. See IRS Revenue Rule 80-364. In limited circumstances attorney fees awarded in a class action settlement will not be considered income or for multiple claimants when the fees can not be attributable to any specific claimant. See IRS Private Ruling 200518017 at <http://www.tjsg.com/JS/index.cfm?event=showPage&pg=newsirsletter>

This tax treatment is consistent with [Internal Revenue Code § 61](#) (Gross Income Defined) and “the long established principle, “the fruit of the tree” theory, that income is taxable to the person who earns it and it cannot be assigned to someone else.” See Lawsuit Awards and Settlements: IRS Tax Law at http://www.weitzlux.com/irs/freetaxeslawsuitsettlementirs_920.html

Additional Tax Reporting for Attorney/3rd Party if Sole Payee or Co-Payee on Payment

Tax reporting follows a simple rule: reporting will be required if you are a payee on a check unless the type of payment is exempt. Additional tax reporting is required when an Attorney or 3rd party is listed as the **sole payee** or **co-payee** on the payment. The Commonwealth is required to issue a 1099-MISC (Box 14) for any attorney or a 1099-MISC (Box 3) for any 3rd party listed as the sole or co-payee on a payment, **in addition** to any W-2 or 1099-MISC issued to the Claimant.

Departments making settlement or judgment payments to a Claimant that include the attorney as the sole or co-payee on the check will be required to obtain an [IRS Form W-9](#) from the attorney (if the attorney is not already on the MMARS Vendor/Customer "VCUST" file) and make the payment using the appropriate object code.

Additional Tax reporting is NOT required if the payment is made out to the Claimant solely and mailed directly to the attorney or 3rd party. However, if a settlement or judgment contains a specific award of Attorney fees, this amount must be made payable directly to the attorney or jointly to the Claimant and Attorney if multiple types of payments are being consolidated into a single check. Attorneys cannot avoid the tax reporting of awarded Attorney fees by requesting that the check be made paid solely to the Claimant.

Example: Claimant is awarded \$5,000 in damages and \$2,000 in Attorney fees. The \$2,000 in Attorney fees must be made payable directly to the Attorney or jointly to the Claimant and Attorney along with the \$5,000 in damages. The \$2,000 in Attorney fees cannot be made payable solely to the Claimant.

Attorney's fees and costs must be specified by name and amount in a settlement or judgment document in order to be paid directly to the attorney. Attorney's fees are paid directly to the Attorney/Firm through MMARS under the TIN or Employer Tax Identification Number of the Attorney or Firm. If a claim includes other payments that are being made jointly to the Claimant and attorney, these amounts will normally be consolidated into a single check made payable jointly to the Claimant and Attorney.

Limited tax exemption for attorney's fees and costs for unlawful discrimination claims and class actions.

The **American Jobs Creation Act** signed into law in October 2004 permits a limited deduction for attorney fees and costs paid in connection with an unlawful discrimination claim and lists the statutes that are included. See IRC § [62\(e\)](#) and IRS [Publication 525](#) Taxable and Nontaxable Income states:

Unlawful discrimination claims. You may be able to take a deduction from gross income for attorney fees and court costs paid after October 22, 2004, for actions settled or decided after that date involving a claim of unlawful discrimination...but only up to the amount included in gross income for the tax year from such claim.

The IRS states: *The American Jobs Creation Act of 2004 enacted IRC § 62(a)(20), thereby establishing an above-the-line deduction for attorney fees and court costs paid in connection with discrimination and certain other suits. In December 2006, the Tax Relief and Health Care Act of 2006 was enacted creating IRC § 62(a)(21), an above the line-deduction for attorney fees and court costs associated with suits involving whistleblower claims.*

In order for IRC § 62(a)(20) to apply, attorney fees and court costs must have been paid after October 22, 2004, with respect to a judgment or settlement occurring after such date. Additionally, the suit must involve -

- o Unlawful discrimination,*
- o Certain claims against the federal government, or*
- o A private cause of action under Medicare Secondary Payer statute*

In order for IRC § 62(a)(21) to apply, the attorney fees or court costs must have been paid in connection with a whistleblower award for providing information regarding violations of tax laws as outlined in IRC § 7623(b), and the information must have been provided on or after December 20, 2006.

The deductions allowed under IRC §§ 62(a)(20) and 62(a)(21) are limited to the amount includible in the litigant's gross income for the taxable year in which the deduction is being claimed. See <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf>.

A Massachusetts state tax exemption was added in 2005. See [TIR 05-15](#) **Deduction for Costs Involved in Unlawful Discrimination Suits.** **IRC §§ 62(a)(20) & 62(e)** Massachusetts adopts the federal deduction allowed for attorney fees and court costs paid to recover a judgment or settlement for a claim of unlawful discrimination, up to the amount included in gross income for the tax year from such claim.

If the claim was not filed under an unlawful discrimination statute, the exemption may not apply. Therefore, claimants should be advised to seek tax advice regarding the tax consequences of these amounts.

Attorney fees awarded to limited group of specifically named claimants who can be individually identified will be reported at the pro rata amount of the attorney fees divided by the number of Claimants, if an individual Claimant's pro rata amount exceeds \$600.00 (unless the claimant is a corporation). See [Attorneys Fees and Costs](#).

Requesting payment to the Claimant's Attorney rather than the Claimant requires additional tax reporting to the attorney **but makes no change in the tax reporting to the Claimant**. Please note that payment of **lump sum** and **back pay** for **current employees** can not be segregated from regular pay nor separately issued or jointly issued to Claimant's Attorney. **Tax liabilities of claimants can NOT be shifted to another party**. Attorney fees are also tax reportable as gross income to the Claimant even if awarded and paid directly to Claimant's Attorney.

4) Interest on Damages and Attorney Fees

Interest on settlements or judgments that are awarded in a settlement or judgment are tax reportable (1099-INT) if the amounts exceed \$10.00 and the payee is not an exempt recipient (corporation, tax exempt organization, etc). See [Instructions for Form 1099-INT](#).

Interest payable under a personnel claim is not considered "wages" and is not subject to tax withholding prior to issuing payment. If other amounts are being processed to a current or former employee through the payroll system, the interest payment can also be processed through the payroll system and included within the check or direct deposit for that employee. A manual 1099-INT will be issued to the employee. If other amounts are not being processed through the payroll system, but are payable to the employee through the state accounting system (MMARS), the interest will be payable under a separate object code (E29) and included in the check or EFT to the claimant, and MMARS will generate a 1099-INT for the interest exceeding \$10. If interest is to be payable along with other amounts payable jointly to an Attorney and Claimant, the 1099-INT will be issued under the same tax identification number as the payee (which is usually the law firm).

The IRS states: *Any interest associated with an award or settlement is always taxable. Aames v. Commissioner, 94 T.C. 189 (1990); Kovacs v. Commissioner, 100 T.C. 124, aff'd, 25 F.3d 1048, cert. denied, 513 U.S. 963 (1993); Brabson v. United States, 73 F.3d 1040 (10th Cir. 1996). Some states have enacted statutes requiring defendants to pay judgment interest in tort actions. Where the parties settle an appeal of a verdict, the Service has been successful in convincing the courts that a portion of the proceeds should be allocated to such interest. Delaney v. Commissioner, 99 F.3d 20 (1st Cir. 1996), aff'g T.C. Memo.1995-378. See p. 23 <http://www.irs.gov/pub/irs-ut/lawsuitesawardssettlements.pdf>.*

Interest will be calculated based upon the date of payment and will be made payable EITHER to the Claimant (through HR/CMS or MMARS as determined by CTR) or the Claimant's attorney (for attorneys fees interest or as part of a joint check) through the state accounting system MMARS. CTR will issue a 1099-INT to the payee receiving the interest.

Interest will either be awarded as a specified amount, or will be calculated at the time of payment in accordance with the rates specified in the settlement or judgment, or as specified in statute.

CTR calculates interest by multiplying the appropriate interest rate by the amount of damages subject to interest, and then dividing this amount by 52 to obtain the weekly interest rate. Then this weekly rate is multiplied by the number of weeks from the date the interest began to accrue until the week the claim is paid. Interest paid to Claimants may be processed and reported through either the payroll system or MMARS.

Interest on a claim is calculated at a weekly rate based upon the index cited in the claim or as identified by the Department. If no index or interest rate is cited in the claim, CTR will use the One Year Constant Maturity Treasury Yield published by the Federal Reserve (<http://www.fedreserve.gov/releases/h15/>) for the week of payment.

See:

- G.L. c. 631, § 6I. Interest Rate; Schedule <http://www.mass.gov/legis/laws/mgl/231-6i.htm>
- Massachusetts District Court Interest Rate Schedule <http://www.mad.uscourts.gov/general/fees-payments.htm>
- Federal Reserve Weekly average one-year constant maturity Treasury yield <http://www.federalReserve.gov/releases/h15/>)
- IRS FORM 1099-INT Instructions <http://www.irs.gov/pub/irs-pdf/i1099int.pdf>
- IRS Tax Topic 403-Interest Received <http://www.irs.gov/taxtopics/tc403.html>

5) **Punitive Damages.**

Punitive damages must be specifically identified as “punitive damages” or other comparable term. Punitive Damages do not require tax withholdings and will be reported to the Claimant on a 1099-MISC (Box 3). See 1099-MISC Instructions Box 3 Other Income at: <http://www.irs.gov/instructions/i1099misc/index.html>

Punitive damages paid to a former employee may be paid solely to the Claimant or jointly to Claimant’s Attorney or a 3rd party and can be processed through HR/CMS or MMARS as deemed appropriate by CTR. For punitive damages paid solely to a Claimant former employee, payment through HR/CMS is preferred rather than MMARS. Payments of punitive damages payable jointly to an Attorney or 3rd party will usually be entered under the TIN/EIN of the Attorney or 3rd party.

6) **M.G.L. c. 258 Tort Claims - Liability Management and Reduction Fund (LMRF)**

The Liability Management and Reduction Fund (LMRF) is used to pay costs that departments incur as a result of non-employment related tort claims under [M.G.L. c. 258](#). Tort claims are claims for damages or loss of property, personal injury or death caused by the negligence, wrongful act or omission of a state or special employee (s) acting within the scope of his/her authority. All M.G.L. c. 258 torts and associated legal costs are paid through the LMRF (Liability Management and Reduction Fund) and are charged back to departments over a 5 year period pursuant to [M.G.L. c. 7A, § 16](#) and the [LMRF Tort Claim Policy](#).

7) **Wrongful Conviction Settlements under M.G.L. c. 258D.**

Although [M.G.L. c. 258D](#) allows for tax exemption by the Commonwealth (for state tax purposes) the Commonwealth is required to report these amounts for federal tax purposes. A state statute cannot waive federal tax reporting requirements. Based upon the statute, the type of claim is not identified as a personal injury or physical sickness tort, but rather a civil liberties violation. Since the claim is not a claim of personal injury or physical sickness, and emotional distress is not deemed a personal injury, a federal tax exemption for this amount is not guaranteed. Irrespective of how the claim is "characterized" the Claimant would have to argue that the total payment was compensation for a personal injury or physical sickness. This is not a determination that the Commonwealth can make, nor should we comment. However, we discuss with Claimant/Counsel that they should be prepared that the IRS might consider all or a portion of the payment as taxable.

Please note that tax reporting does not automatically mean taxable. The Commonwealth can not advise as to the taxability of these types of claims, and questions from the claimant/counsel on the ultimate taxability of this claim should be referred to a tax expert. The Claimant should include the statutory language ([M.G.L. c. 258D](#)) as part of filing his tax return to enable the full exemption from state taxes.

Please note that there may be an exemption from taxes for attorneys fees paid under the claim. Under IRC 62(e) the exemption applies to "any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law— (i) providing for the enforcement of civil rights." While we make no representations about whether c. 258D claims qualify as the enforcement of civil rights, this information may be helpful for tax preparation purposes.

6) **Claims Not Subject to Tax Reporting or Taxes for Claimant**

The full amount of any settlement or judgment will be included as gross income to the Claimant, unless the payment falls within a tax reporting exception. The Commonwealth is not required to file tax reports for a Claimant for the portion of a claim that represents the following:

- a) **Property Damage Torts. Non-employee G.L. c. 258 tort claims for reimbursement of actual damages for repair or replacement costs for property damages.** Departments are required to certify that payments for tort claim property damages represent actual damages, rather than a ***lump sum*** payment to resolve the claim. ***Lump sum*** claims require tax reporting by the Commonwealth. Therefore, Claimants are required to document or substantiate claimed property damages to ensure that the reimbursement does not qualify as a capital gain to the Claimant or trigger tax reporting by the Commonwealth. Tort claim property damages that are reimbursed by the Commonwealth cannot also be claimed as a casualty loss on Claimant's tax return. Amounts paid for property damages which exceed the basis of the repaired or replaced property must be claimed by the Claimant on his/her tax return. See IRS Topic 515 "Casualty, Disaster, and Theft Losses" <http://www.irs.gov/taxtopics/tc515.html>.
- b) **Property Damage Torts - Subrogation. Non-employee G.L. c. 258 tort claims subrogation reimbursements to an insurer for actual damages repair or replacement cost for property damages.** These payments represent reimbursements to insurance carriers for property damages already paid out to insurer Claimants. The Commonwealth accepts the amount paid to the insurer as representing actual damages which does not trigger tax reporting by the Commonwealth for the Claimant. A 1099-MISC is issued to the insurer for any payments made.
- c) **Personal Injury Torts. Non-employee G.L. c. 258 tort claims damages on account of personal physical injuries or physical sickness.** Four requirements must be met.
- i) The Claimant must be a non-employee. Tort claims for personal injury or sickness arising out of employment cannot be brought by an employee. The damages must be for a G.L. c. 258 tort or tort-like damage. See [Commissioner v. Schleier](#), 515 U.S. 323 (1995);
 - ii) The Claimant must have suffered a personal injury or physical sickness as a direct result of the tort. See IRC 104(a)(2) <http://www.fourmilab.ch/ustax/www/t26-A-1-B-III-104.html> and [Commissioner v. Schleier](#), 515 U.S. 323 (1995)
 - iii) There must be a direct link between any related damages (lost wages, medical expenses, pain and suffering and emotional distress) and the physical injuries or physical sickness caused by the tort. See [Commissioner v. Schleier](#), 515 U.S. 323 (1995);

For example, a non-employee Claimant injured in an automobile accident claims lost wages, medical expenses, pain and suffering and emotional distress. This Claimant must prove that each element of these damages arose directly from the physical injuries or sickness caused by the accident in order for these damages to be excludable from tax reporting. If any portion of a claim, such as emotional distress damages, did not arise "directly from physical injuries or physical sickness" then these damages are tax reportable.

The IRS states in the "IRS Memorandum Employment Related Judgments and Settlements" See <http://www.mwe.com/info/pubs/irscounselmemo.pdf>:

"In order for the amount to be excluded from gross income under § 104(a)(2), the taxpayer must demonstrate that the amount was received on account of personal physical injuries or physical sickness, or as reimbursed expenses for medical treatment for emotional distress. See, e.g., Prasil v. Commissioner, T.C. Memo. 2003-100, applying the two tests set forth in Commissioner v. Schleier, 515 U.S. 323, 336-37 (1995), to the current version of § 104(a)(2), i.e., under current law (1) a claim must be based upon tort or tort-type rights, and (2) the taxpayer must show that the damages were received on account of personal physical injuries or physical sickness."

"What is a personal physical injury?"

Our administrative position is that observable or documented bodily harm, such as bruising, cuts, swelling or bleeding is evidence of personal physical injury. If there has in fact been a personal physical injury, compensatory damages for consequential emotional distress related to the injury are also excludable from gross income.

In Rev. Rul. 85-97, 1985-2 C.B. 50, amplifying Rev. Rul. 61-1, 1961 C.B. 14, the Service considered a situation where an individual received a lump sum payment in settlement of an action against a bus company for negligent operation of a bus that caused him serious bodily injury and the concomitant loss of wages and earning capacity. The ruling holds that the entire recovery was for personal injuries excludable from gross income, including the portion allocable to lost wages."

The IRS states: "*In Emerson v. Comr., T.C. Memo 2003-82, the Tax Court found that a tort recovery for various claims, including emotional distress, was not excludable under IRC § 104(a)(2) because the recovery was not received on account of personal physical injuries or physical sickness. Also, in Witcher v. Comr., T.C. Memo 2002-292, the Tax Court held that a tort recovery for various claims, including emotional distress and defamation, was not excludable because it was not received on account of personal physical injuries or physical sickness.*" See p. 13. <http://www.irs.gov/pub/irs-ut/lawsuitesawardssettlements.pdf>.

o **Civil Rights Claims - With claim of Personal injury or personal sickness.**

Some civil rights claims identify a tort-like damage with resulting personal injury or sickness which is filed in state or federal court outside the tort claim act under c. 258. Personal injury and property damage claims awarded under G.L. c. 258 are automatically exempted from tax reporting and are exempt from taxes. Civil rights claims with a claim of personal injury or personal sickness are not automatically exempted from tax reporting and are not automatically exempt from taxes. Therefore, since each case is treated on a case-by-case basis, the Commonwealth will withhold on civil rights employment claims and report these amounts as wages on a W-2 prior to payment and will issue a 1099-MISC (Box 3) for non-employment claims. The claimant may claim a refund or exemption under IRC s. 104 when filing a tax return. Given the likelihood that the IRS may not agree that the type of civil rights damages support a IRC s. 104 exemption, the Commonwealth reserves the right to take the withholdings and provide tax reporting at the time of payment.

d) **Employee or non-employee reimbursements for substantiated medical expenses for emotional distress.**

Damages for emotional distress are tax reportable. However, a specific award amount representing reimbursement for documented actual expenses for medical care for emotional distress (costs which have not already been covered by insurance) are not tax reportable by the employer as income to the Claimant. The settlement or judgment must specify an amount and that the amount is for medical expenses for emotional distress. Cancelled checks or other proof of payment, proof that the expenses were for qualified medical care and that the expenses were not offset by insurance must be provided to the Department in order for the Settlement or Judgment to contain an award amount identified as medical expenses for emotional distress. These reimbursed costs may **not** also be taken as a medical costs deduction on the Claimant's tax return.

e) **Employee or non-employee "class action" claims which do not identify a specific amount of damages to be awarded to named Claimants.**

For claims with multiple claimants, tax reporting and withholdings are determined by how the award is structured. Claims may not be settled or awarded in a manner to shift the tax reporting responsibilities to the Attorney or a 3rd party. Therefore, if Claimants are awarded damages other than Attorney fees and costs, the award must specify the amount of damages for each Claimant to enable the Commonwealth to perform appropriate reporting and tax withholdings. If it is possible to calculate the amount of an award to be paid to each of the class participants, individual payments must be made and tax reporting will be required unless the amount for any Claimant is less than \$600 or a Claimant is a corporation or another exemption exists. The following examples identify when a class action "et. al." award will or will not trigger tax withholding or reporting requirements:

- Example 1: Award of attorneys fees was to a Public Interest law firm representing a class of non-employee Claimants in which individual claimants were not individually named and attorney fees in the amount of \$5,000. The attorney fees payment is issued to the law firm. The Commonwealth would provide an IRS 1099-MISC (Box 14) for the \$5,000 to the

law firm. However, since the class members are not individually named in the award, no tax reporting will be made to the class members.

- Example 2. Award of damages was made to class of non-employee Claimants in which 10 class members were individually named. The payment is issued to the firm on behalf of the class. The Commonwealth would provide an IRS 1099-MISC (Box 14) for the \$5,000 to the law firm. Even though the individual class members were named and are therefore “identifiable” the Commonwealth would not be required to provide a 1099-MISC (Box 3) to each of the named claimants for the pro rata share of \$500 since this amount does not meet the \$600 threshold for 1099-MISC reporting.
- Example 3. Award of damages was made to class of employee Claimants in which 10 class members were individually named and individual amounts for **lump sum** or **back pay** awards were specified. The payments must be processed through the payroll system to ensure the appropriate tax withholdings are made and W-2s are issued to the Claimants. The Commonwealth would provide an IRS 1099-MISC (Box 14) for any payments which included the attorney’s name as payee on the payment.
- Example 4. Award of \$6,500 in attorney’s fees was made to law firm representing class of non-employee Claimants in which 10 class members were individually named. The payment is issued to the firm on behalf of the class. The Commonwealth would provide an IRS 1099-MISC (Box 14) for the \$6,500 to the law firm. Since the individual class members were named and are therefore “identifiable” the Commonwealth would be required to provide a 1099-MISC (Box 3) to each of the named claimants for the pro rata share of \$650 since this amount exceeds the \$600 threshold for 1099-MISC reporting.

f) Legal Representation Costs and Employee Indemnification authorized under G.L. c. 258, § 9 and § 9A. (not tax reportable to employee) When a lawsuit is filed against the Department or its staff in a state or federal court, the Department is required to immediately notify the Attorney General’s Office (AGO). The AGO determines whether or not it will be able to provide legal representation to defend the lawsuit or whether the Department or any individually named employee (current or former) will be required to obtain outside counsel to defend the suit.

i) Civil Litigation against the Department as Defendant. In many cases, when civil litigation is brought against a Department the Office of the Attorney General provides legal representation to defend the Department. When the Office of the Attorney General determines that it can not provide legal representation for the Department due to a conflict, the Department has two choices for obtaining legal counsel:

- (a) Procure outside legal counsel to represent the Department. Executive Departments seeking representation by outside counsel must comply with 801 CMR 21.00, M.G.L. c. 30, § 65 and Object Code H09 or N03 in the Office of the Comptroller [Expenditure Classification Handbook](#). Selected counsel must be appointed by the AGO as a Special Assistant Attorney General (SAAG) in order to represent the Commonwealth; OR
- (b) Have an existing Department Legal Counsel appointed by the AGO as a Special Assistant Attorney General (SAAG) if the counsel is sufficiently experienced in the type of civil litigation at issue, and the SAAG designation is approved by the Department Head.

ii) Legal Fees and Costs. All costs associated with legal representation by the AGO (expert witness, depositions, court reporters etc.) are paid by the Department to the AGO through an Interdepartmental Service Agreement (ISA) under the [ISA policies](#) issued by CTR. ISAs must be in place with funding reserved PRIOR to any obligations being incurred. Costs may not be incurred and bills sent to the Department for payment. Payments must be made in the fiscal year in which the obligation is incurred. Departments should work with ANF and CTR to ensure that sufficient funds are available for litigation costs for litigation which cross fiscal years. Contracts for legal services may not pay a “retainer” in advance of services being performed. Contracts must encumber sufficient funds to support the anticipated costs of litigation but may not advance funds to an attorney prior to the provision of services and may not craft language that a retainer is due as a first payment once services have begun. Payments may be made within the first week of service subject

to Prompt Payment Discounts for accelerated payments in less than the standard 45 day payment cycle. See the [Commonwealth Bill Payment Policy](#).

iii) **Civil Litigation against Specifically Named Employees (Sued in official capacity).**

When civil litigation is brought against a specifically named employee (current or former) in his/her official capacity, the Office of the Attorney General provides legal representation to defend the employee. When multiple employees are named, or when an employee is sued in his/her personal capacity (not acting within the scope of employment), or there may be another conflict, the Office of the Attorney General determines whether or not the AGO can provide legal representation for the employee(s). For claims against a specifically named employee of the Department (current or former) for which the Office of the Attorney General determines it can not provide legal representation due to a conflict, the Department has two choices:

- Procure outside legal counsel to represent the employee. Executive Departments seeking representation by outside counsel must comply with 801 CMR 21.00 and M.G.L. c. 30, §65 and Object Code H09 or N03 in the Office of the Comptroller [Expenditure Classification Handbook](#). See **Legal Fees and Costs** section above. Selected counsel must be appointed as a Special Assistant Attorney General (SAAG). In cases in which the Department is also a defendant, or when a conflict of interest may be present, the Department should not procure outside counsel directly, but require the employee to procure his/her own outside counsel.
- The employee sued in his/her personal capacity may procure his/her own outside counsel. The Department would sign an Indemnification agreement with the employee and outside counsel outlining the conditions for reimbursement of legal expenses and other costs, including damages if determined appropriate and subject to approval by the Department and if an Executive Department, approval by ANF. The Department may also require certain minimum qualifications for the attorney (to ensure that the counsel is qualified to provide the type of legal services required), and also limit the rate that the Department is willing to indemnify to contain exorbitant legal costs for the Commonwealth. The Commonwealth is not required to indemnify unreasonably high or inflated litigation costs. All fees and costs must be documented and reviewed by the Department prior to payment.
 - (a) For Executive Departments, all indemnification agreements must be approved by ANF Legal prior to incurring any legal costs.
 - (b) Indemnification agreements may not agree to any retainers or advanced funding.
- Employees sued in his/her official capacity are entitled to legal representation or indemnification of any awarded damages, subject to certain conditions. See [G.L. c. 258, §9 and § 9A](#). Employee indemnification expenses include legal fees, costs and damages (not to exceed one million dollars) arising out of a claim by reason of any claim, action, award, compromise, settlement or judgment by reason of an intentional tort, or by reason of any act or omission which constitutes a violation of the civil rights of any person under any federal or state law; if such employee or official at the time of such intentional tort or such act or omission:
 - (a) Was acting **within the scope of his official duties or employment**; and
 - (b) For employees who are not constitutional officers, the employee was **NOT** found to have acted in a “**grossly negligent, willful or malicious manner.**” Or for police officers, did not act in a “**willful, wanton, or malicious manner.**”

Indemnification will not be authorized at the conclusion of litigation, if the employee is found to have failed one or both of these conditions. If the Commonwealth has paid for legal representation costs during litigation, the employee will be required to pay back all fees. Employees sued in his/her personal capacity cannot be indemnified by the Commonwealth unless the conclusion of litigation determines that the employee met the requirements above.

- Depending upon the circumstances, the legal costs associated with the Department's defense of a claim or an employee may be paid directly to the attorney or firm providing representation using Department funds, or may be submitted to CTR for

payment from the Settlement/Judgment Reserve Account. Indemnification payments from the Settlement/Judgment Reserve Account for employee defense expenses will not be made unless the Department certifies that the requirements for Employee indemnification listed above have been satisfied. Indemnification payment may be made during the course of litigation, only if the Department and employee certify in writing that:

1. to the best of the Department and employee's knowledge and belief that the two criteria for Employee Indemnification have been met,
2. that requiring the employee to pay for litigation expenses up front would present an unreasonable financial burden for the employee and that the employee is not able to obtain adequate legal representation without such funding, and
3. that if at the conclusion of litigation either of the Employee Indemnification requirements are not met, that the Department will seek recoupment of the funds from the employee and the employee agrees to automatic intercept or garnishment of funds from any Commonwealth funds payable to the employee.

Employee legal representation costs are **NOT** normally considered normal department expenses from operating funds and subject to CTR approval may be eligible for payment from the Settlement and Judgment Reserve. Departments choosing to pay for legal costs using Department funds may not later seek reimbursement from the Settlement/Judgment Reserve Account. Attorneys receiving payments will receive a 1099-MISC for the amount of payment. Reimbursements to employees or payments made on behalf of employees for legal representation are not tax reportable, provided the Commonwealth is reimbursing the employee for substantiated expenses or making payments to an attorney at the conclusion of litigation. See [G.L. c. 258, § 9](#) and [G.L. c. 258, §9 A.](#)

- iv) **Administrative Claims.** When an administrative claim is filed against a Department or its staff in an administrative forum (MCAD, EEOC, LRC etc.) the Department is responsible for defending this claim, either by having in-house counsel, the Human Resources Division (employment claims) or by hiring outside counsel in compliance with G.L. c. 30, § 65, 801 CMR 21.00 and the Office of the Comptroller [Expenditure Classification Handbook](#). See **Legal Fees and Costs** section above. All legal costs are paid by the Department and the Department must identify or seek funding for these costs or consult with CTR relative to funding from the Settlement and Judgment Reserve. Administrative claims that are appealed or transferred to a state or federal court must be referred to the AGO for representation by the AGO or an approved SAAG. Representation costs or damages awarded against employees defended in administrative actions (other than orders for personal damages) are not tax reportable as income to the employees. Resulting awards of damages to Claimants are tax reportable based upon the damages awarded consistent with this Policy.

FUNDING SOURCES FOR SETTLEMENTS AND JUDGMENTS.

Claims may be paid only with “legally available funds” as defined under 815 CMR 5:00 which include funds appropriated “**specifically for the payment of settlements and judgments**” or authorized for the payment of certain contractual expenditures. Legally available funds do not include any funds not specifically authorized by 815 CMR 5.00 for use in the payment of judgments and settlements, including any legislatively authorized “special funds” and trust funds as defined in M.G.L. c. 29, § 1. Special funds and trust funds must be used solely to further statutorily authorized goals, which should not be interpreted to automatically include the payment of judgments and settlements unless these payments are specifically authorized for the funds.

Budgetary operating funds, federal grants, trust funds, capital funds and other types of funds are not appropriate for settlements and judgments without specific language and should not be used to make claim payments. Even if claim payments are court-ordered or settled to be paid immediately by a Department, these payments are “subject to appropriation” similar to all other payments and must be paid with funds legally authorized by the Legislature. Departments may not make payments prior to CTR approval in accordance with this policy.

The following guidelines should be considered when determining the source of funding for a particular claim.

- 1) **M.G.L. c. 258 TORTS.** All M.G.L. c. 258 torts and associated legal costs are paid through the LMRF (Liability Management and Reduction Fund) and are charged back to departments over a 5 year period pursuant to [M.G.L. c. 7A, § 16](#) and the [LMRF Tort Claim Policy](#). Departments do not have the option of directly paying tort claims through operating or other funds since the Legislature requires by statute that all tort payments are recorded through the LMRF. Departments are responsible for requesting sufficient operating funds to cover the annual amounts for tort chargebacks. LMRF claims are submitted to CTR with the appropriate LMRF Authorization Form processed from the LMRF Application and supporting documentation. Payments are processed from the LMRF Fund and chargebacks are managed upon payment of the claim.

The LMRF is not used for cases filed and awarded in federal court for “tort-like” damages under statutory or civil rights statutes, c. 258D wrongful conviction claims, non-employee civil rights claims or any current or former employee claim, including workers compensation.

- 2) **SETTLEMENT AND JUDGMENT RESERVE (1599-3384 or other S&J Reserve).** The S&J Reserve is the default account for all non-tort settlement and judgment claims when a department does not have sufficient “legally available funds.” The S/J Reserve must be used for any claims from “former employees” who have left state service in a prior fiscal year (irrespective of which fiscal year the final claim is paid), and for all damages, legal representation costs, indemnification costs associated with non-tort settlements or judgments and contract claims that have been litigated and for which contract funds are no longer available under the contract giving rise to the claim. Non-tort claims paid through the S&J Reserve account are not currently charged back to departments. The S/J Reserve account is traditionally funded by the Legislature in the GAA and often undergoes several supplemental appropriations throughout the fiscal year based upon the volume of claim obligations. The timing of any GAA appropriation or supplemental appropriation is uncertain, therefore the timing of payment cannot be guaranteed or negotiated as part of the settlement or judgment. The availability of funds depends upon the volume and size of claims submitted at any given time during the fiscal year. CTR has no control of when budget requests are filed by the Administration or when appropriations will be available for payment.

Funds Availability - BQ89 MMARS Page Search. Departments can see available funds in the 1599-3384 account in MMARS by doing a Page Search “BQ89” and then searching the current Budget Fiscal Year and “15993384” under Appropriation. The amount under “Expenditure Ceiling” is the amount that has been appropriated and allotted for expenditure. Funds are not available for expenditure unless appropriated and allotted. The amount under “Unexpended” is the amount remaining in the account as of that date, subject to any claims in process that have been submitted to CTR for payment but have not yet been processed through payroll or MMARS. Funds availability can only be determined at the time a claim is put in line for payment and processing.

- 3) **NON-TORT EMPLOYMENT. (Former Employee).** All employment-related claims involving a former employee who was terminated, died, retired, or who resigned in a **prior fiscal year**, must be paid from the S&J Reserve account and may not be paid using current department payroll appropriations, which are not legally authorized for these types of claims. Higher Education

University or Community Colleges may use non-appropriated local trust funds if the trust language is broad enough to cover this type of expenditure.

- 4) **EMINENT DOMAIN.** All eminent domain payments are paid from capital or other appropriations authorized for the related land acquisition and are not paid by CTR. Claims submitted to CTR will be forwarded to the General Counsel of the Department subject to the Eminent Domain claim.
- 5) **DEPARTMENT FUNDS.** Departments seeking to use Department funds to pay a claim must obtain prior written approval from CTR for use of these funds and follow the standard CTR review process for settlements and judgments to obtain payments instructions.
 - a) **NON-TORT CONTRACT claims.** Contract claims should be paid from the Department appropriation(s) currently funding, or available to fund, the contract in dispute. Payment of claims involving a terminated contract when the funding appropriation has also terminated, will be determined by CTR as either a prior year deficiency (PYD) which will be charged back to a current Department contract appropriation (usually done for settlements of a contract claim) or the [S&J Reserve account](#) (usually done only for judgments or administrative rulings against the Commonwealth relative to a contract claim with an expired payment account). Contract claims require prior review and approval of instructions by CTR.
 - b) **NON-TORT EMPLOYMENT (Current Employees).** Employment related claims for current (active) employees, or former employees who were last paid by the Department on the current fiscal year's payroll (they were terminated, resigned, died or retired in the current fiscal year) may be paid from current department appropriations ONLY when the following five (5) conditions are met:
 - i) the payment is for **back pay** or reimbursement damages. (All other non-payroll costs such as , lump sum, front pay, emotional distress, attorneys fees, legal costs, punitive damages and interest may not be paid with current payroll funds but must be paid by special appropriation or the [S&J Reserve](#)). The one exception to lump sum payments is for "**overtime**" that was not paid which may be paid using current fiscal year payroll funds upon approval by CTR. Other "compensatory" damages for emotional distress, unspecified damages or damages to settle a case may not be paid from current payroll funds.
 - ii) the Department determines that payment of the claim from payroll funds is a necessary and appropriate business payroll expenditure, AND
 - iii) the payment does not create ANY risk of the Department running into a payroll deficiency at any time in the fiscal year (Executive Departments must confirm with ANF), AND
 - iv) the payment will not significantly impair payroll related funding necessary to conduct department business.
 - v) Prior review and approval of instructions by CTR.
 - c) **NON-TORT CIVIL RIGHTS OR OTHER NON-EMPLOYMENT CLAIMS.** Non-employment related claims may be paid from current Department appropriations or other available funds ONLY when the following four (4) conditions are met:
 - i) the appropriation or fund language is broad enough that it can be interpreted to legally cover this type of expenditure AND
 - ii) the department determines that payment of the claim from available funds is a necessary and appropriate business expenditure, AND
 - iii) the payment does not create ANY risk of the department running into a funding deficiency at any time in the fiscal year (Executive Departments must confirm with ANF), AND
 - iv) the payment will not significantly impair funding necessary to conduct department business.
 - v) Prior review and approval of instructions by CTR.

Departments that choose to use Department funds may not later seek reimbursement from the Settlement/Judgment Reserve. See [Expenditure Correction Policy](#).

6) **SPECIAL APPROPRIATIONS**

For exceptionally large claims or claims with extenuating circumstances, CTR or ANF may require a separate special appropriation. Departments in the midst of litigation or settlement negotiations with any claim anticipated to exceed \$1,000,000 dollars MUST consult with CTR and ANF (if budgetary requests are processed through ANF) to determine whether the claim should be submitted to be put in line for payment under the S&J Reserve, or a separate special appropriation should be filed.

CTR and ANF review is also required for any "consent decree" or other settlement or litigation that MAY require the Commonwealth to "commit" funds, resources or services that will require a new or continued funding commitment. All such funding is subject to appropriation and must be supported through the normal budgeting process. No state official or Attorney has the authority to legally bind the Commonwealth to any future fiscal obligation without two-thirds approval of the Legislature through the appropriation process. Any settlement or order will be subject to appropriation. CTR and ANF must be notified immediately of any "potential" consent decrees, orders settlements or litigation that may be finalized in the current or next fiscal year and no such claim may be finalized without a plan for funding approved through ANF or appropriate budget authority.

As the result of certain settlements or judgments a Department maybe required to fund ongoing periodic payments for consent decree, medical costs, legal costs or court monitor review or other costs as part of the claim resolution. In these cases, the ongoing costs are considered a Departmental operational cost and the Department will be required to maintain sufficient appropriations to cover these ongoing compliance costs, since these costs are considered part of the Department's ongoing operational responsibilities to fulfill the settlement or judgment. These mandated payments will not default to the S&J Reserve if the Department fails to obtain the necessary funding, or the Department undergoes M.G.L. c. 20, s. 9C allotment reductions, and the Department will be responsible for taking the necessary steps to adjust internal expenditures or initiate the deficiency process under M.G.L. c. 29, s. 9E.

Processing Steps for Settlement and Judgment CTR and Approval of Payment Instructions

- 1) Prior CTR review is required for all claims, even if the Department plans to make payment, to ensure that payment is made consistent with state and federal tax reporting and withholding requirements, the terms of the claim documentation and state finance law requirements. Note: Departments that enter claims without CTR review and instructions will be responsible for all actions necessary to back out the transactions and properly record the payments.
- 2) **CERTIFIED TRUE ATTEST COPIES (NOT ORIGINALS)** of Settlement and Judgment and c. 258 Tort Claims are submitted to the Office of the Comptroller (CTR) along with the applicable Authorization Form and all supporting documentation to support payment. The Department or Agency Counsel is responsible for completing a Settlement and Judgment Authorization Form and providing of the all supporting documentation outlined in the Form instructions.
 - a) Claim documents may be submitted by mail, email or fax to the CTR Legal Unit for review in order for a claim to be processed (even if the Department is paying the claim with Department funds) to ensure that proper instructions are received for payment processing.
 - b) The Department is responsible for retaining the record original copies of all settlement or judgment documents for records retention purposes. *DO NOT include internal memorandum discussing the claim or other internal department or attorney/client documents that are not part of the judgment. These documents should be retained in the department's internal files.*
- 3) Claims may not be submitted to CTR and put in line for payment unless the claim is final, with no further appeals or reviews. CTR can not approve partial payments pending conclusion of final disposition of a claim.
 - a) For consent decrees, a claim will not be put in line for payment until all documents triggering the payment obligation have been executed by the parties (unless the obligation for payment is contingent upon the filing of any documents, such as the consent decree or court approval of the decree.)
 - b) For class actions involving multiple claimants receiving payments, a claim will not be put in line for payment until all documents triggering the payment obligation have been executed and all

claimant releases have been obtained and are approved by the Class Counsel as accurate and complete.

- c) For litigated cases, a Stipulation of Dismissal must be executed by all parties even if filing with the Court is delayed until Claimant's receipt of payment.
 - d) Settlements cannot be put in line for payment unless the Claimant has signed a Release of all future claims related to the same issue, which may be included as part of the Settlement Agreement. Note that any separate Release document must identify the "total" amounts awarded under the Settlement including amounts paid on behalf of the Claimant to the Claimant's Attorney or another 3rd Party.
- 4) Claims received by noon on any business day are date stamped by CTR with that date. Any claim received after noon on any business day will be date stamped on the next business day. Faxing documents will expedite the date a claim is put in-line for payment ONLY if faxed documentation is complete.
 - 5) Claims are put "in line for payment" once all documentation has been received "Complete" and reviewed by CTR and the claim payment instructions have been finalized. Depending upon the number of claims submitted at any given time, it normally takes 5 business days to review a claim once all the paperwork has been received "complete." If any paperwork is missing or is submitted at a later date, the claim can not be reviewed until completed.
 - 6) Any HR/HRCMS re-hiring updates for former employees being paid must be finalized no later than the Friday prior to the scheduled payroll payment date. Payroll payments must be entered by the Department using the CTR provided instructions no later than the Monday preceding the scheduled payroll payment date. CTR Payroll will enter the LCM rules to direct the payroll charges to the S&J 1599-3384 account or other appropriate account.
 - 7) Payroll claim payments for former employees who have since been rehired by another Department will be treated as a payment for a "current" employee and CTR will work with both the claimant Department and the current employer Department to enter payment and enter the LCM rules to direct the payroll charges to the S&J Reserve account 1599-3384 or other appropriate account.
 - 8) Failure to submit the required documentation or failure to correctly complete the Non-Tort Settlement/Judgment Payment Authorization Form or the LMRF Tort Claim Authorization Form will delay the claim from being placed in-line for payment. Claims cannot be put in line for payment if a Claimant or Claimant's Attorney refuses to sign a Settlement Agreement, Release or Stipulation of Dismissal (although the Agency Counsel can agree to withholding filing of the Stipulation until the claim is confirmed as paid.). CTR is unable to process claims without completed information and certified/attested copies of the required documentation, without exception.
 - 9) All Communication during the processing period will be made between CTR and the AAG/SAAG or Agency Counsel handling the claim for the Department subject to the Claim. **CTR will not communicate with or respond to email or telephone inquiries from anyone other than the AAG/SAAG or Agency Counsel looking for information about a claim.** CTR has no authority to communicate any information directly with a Claimant or Claimant's Attorney. Requesting status updates for a claim slows down the processing of all claims. CTR will contact the Department/AAG or SAAG if paperwork is incomplete. CTR will not provide status updates for the availability of funds in the S&J account for settlement or judgment negotiation purposes, the approximate time period for payment, or where the claim is relative to processing order. CTR will verify if sufficient funds are available to pay a claim and the anticipated timing of payment **ONLY** when a claim has been placed "in line for payment" after the claim paperwork has been reviewed and is ready for payment instructions and processing. Payroll instructions for payroll claims and Department paid claims will be emailed to the Payroll Director (listed on page 1 of the Authorization Form) and the CFO.
 - 10) CTR will not identify a specific order of any claim in line for payment, but will upon request, identify the approximate number of claims in line ahead of any claim to the Agency Counsel, Department or AAG assigned to the claim. CTR will not communicate approximate payment dates to claimants, claimant counsel, the Legislature or any other interested party.
 - 11) When sufficient funds are appropriated and loaded into MMARS, claims are processed in the order the claims are in line for payment. Payments are made based upon the "in line for payment" order, subject to the availability of funds. If sufficient funds are available to make payment, CTR will take the necessary steps to make MMARS payments (non-payroll portions of claims) and issue

instructions for Departments to enter payroll related portions of claims through the state payroll system (HR/CMS) for bi-weekly payroll payments.

- 12) Payroll portions of claims are processed according to the bi—weekly payroll cycle which may result in delays in payment if claims are submitted too late in the pay period for payment in the current pay period and have to wait until the next pay period.
- 13) NOTE: CTR is not mandated to issue payments according to any specified payment date, but processes claims in line for payment as expeditiously as possible given staff resources and with the necessary steps to ensure the complete processing of claims in the order claims are in line for payment. If payment is issued after any specified payment date in the settlement or judgment, and late payment interest is required, CTR will calculate the amount of interest required under the claim and issue this interest as an additional payment along with the claim.

Claimant and Payee Tax Identification Information Mandatory Verification

As with any other payment, CTR relies on the Department Head's certification that the paperwork provided is legal, accurate and complete, including tax information and verification for any payee. See [Department Head Signature Authorization Policy](#) and W-9 and [Vendor Customer Policy](#) (intranet). CTR is responsible for ensuring that payment reaches the intended recipient identified in the claims and that the funds are not fraudulently misdirected for any purpose, including tax evasion. Therefore, CTR relies upon Departments and the Agency Counsel as responsible for verification of the legal name, legal address and tax identification number (TIN) or Federal Employer Identification Number (FEIN) for any claimant AND any other payee receiving payment (attorney, insurance company, estate, 3rd party payee). At a minimum, the Department or Agency Counsel should obtain a written certification from claimant or counsel that the payee information is accurate and complete.

If the claimant or other payee is already on either HR/CMS the Department and Agency Counsel are responsible for identifying the correct HR/CMS id, record number, position number and account associated with that position number for the employee and verifying that the legal address is still valid for W-2 reporting purposes. If the employee is a former employee, a W-9 should be obtained to verify the current legal name, legal address and TIN.

For MMARS payees, the Department is responsible for identifying the correct MMARS Vendor Code number on VCUST and verifying that this record matches the W-9 or other verification that the Department conducts routinely to verify the legitimacy of payees or the paperwork obtained from the Agency Counsel to verify that the VCUST information is still valid. If the information does not match the Department is responsible working with the Agency Counsel to verify the correct current Legal Name, Legal Address and TIN for TAX FILING PURPOSES in addition to any separate REMITTANCE address for where payments will be made. If the TAX FILING name and address do not match the Department and Agency Counsel are required to obtain a W-9 form from the payee, verifying that the information is accurate and complete. This verification should be submitted for all claims paid by CTR, and retained in the claim file for all claimants paid directly by the Department in accordance with CTR instructions.

Departments and Agency Counsels SHOULD NOT merely request that a Non-employee Claimant or Attorney submit a new W-9. They MUST take the step of verifying the TIN or FEIN and search in VCUST. If the Claimant or Attorney complete the W-9 incorrectly indicating a "remittance" address for where they want the check or payment sent, instead of both the legal address for tax filing purposes (which is recorded with the IRS and DOR), the changes will be made in VCUST in MMARS and the tax filing information will create a red flag for tax return purposes. Therefore, Agency Counsels are responsible for obtaining copies of the current VCUST information (Payment addresses) and the 1099 Table (Legal Address table for tax filing purposes) to verify that this information is accurate.

Note also that as part of this review, the Department and Agency Counsel need to verify if the VCUST table for the Payee is set up for EFT payments. If so, it does not matter what is listed for a payment address in the VCUST table, all payments will be issued into the bank account listed on the VCUST Table. When negotiating the claim, it should be noted if payments will be made electronically (which is the default option for recurring payments.) Law firms receiving routine payments will be required to accept payments through EFT.

For Class Actions with multiple claimants submitting substitute W-9s and spreadsheets being submitted from Claim Administrators to upload to the VCUST file, the Claim Administrator and Class Counsel will be required to perform the required verification and certify to CTR that the information is accurate and complete. CTR will perform routine IRS data matching to identify any irregularities,

invalid TINs or TIN and Name mismatches to prevent the unauthorized distribution of payments. See <http://www.mass.gov/osc/docs/policies-procedures/accounts-payable/po-ap-vendor-customer-w9.doc>

Electronic Fund Transfer (EFT/Direct Deposit).

Payments will default to EFT/direct deposit (rather than a check) if the payee is already set up for EFT on the state payroll or accounting systems. Payroll claims for **back pay** and **lump sum** damages for current employees must be processed along with regular wages and cannot be split out into a separate check, or made payable jointly to an attorney or 3rd party payee.

Payees who anticipate receiving routine or multiple payments of at least 4 payments per year will be required to be [set up for EFT](#), including law firms representing plaintiffs. See Fiscal Year Update #2012-07 <http://www.mass.gov/osc/guidance-for-agencies/fiscal-year-updates/fy2012/fy2012-07.html>

Vendor Web and Vendor LookUp for Details of Payments

Vendor Web (Internet). Claimants/Attorneys can verify MMARS payments Remittance details related to payments at **Vendor Web** at: <https://massfinance.state.ma.us/VendorWeb/vendor.asp> with Vendor Code and the last four digits of the Tax Identification Number associated with that Vendor Code. Vendor Codes can be provided to payees from the Department responsible for the claim.

Vendor Lookup (Intranet). Departments and Agency Counsels can look up MMARS payments through **Intranet Vendor Look Up** at: <http://ctrpartnernet.ctr.state.ma.us:1645/VendorLookup/VendorLookup.aspx> with Payee name or Vendor Code.

See: Electronic Funds Transfer Policy contained in the [Bill Payment Policy](#).

Payment Options and Authorized Payees for Settlements and Judgments

Payments will be issued to payees listed in the settlement and judgment documents. If the settlement or judgment is silent, payment will be issued to the named Claimant. If multiple claimants are named in a settlement or judgment, each with specified amounts, separate checks will be issued to each Claimant for the specified amount. If multiple Claimants are named and specified amounts are not named for each Claimant in the Settlement and Judgment, separate checks will not be issued without signed releases from each Claimant identifying the amount of his/her portion of the claim.

Income, net proceeds, or fee assignment agreements between a Claimant and Attorney or a 3rd party are not binding upon the Commonwealth and will not be honored for the purposes of making payment solely to an Attorney or 3rd party or changing the Commonwealth's tax withholding or reporting responsibilities related to the Claimant. Authorized 3rd party payees include Claimant insurers; administrators of an estate for the Claimant or other payees authorized in the settlement or judgment.

Payments will not be issued solely or jointly to an Attorney or other 3rd party unless the authorized payee is listed as a payee in the settlement or judgment or the Claimant has signed a release identifying that payment may be issued jointly or solely to his/her attorney or an authorized 3rd party.

The tax treatment for claims is determined by the type of claim filed and the types of damages awarded as part of the settlement or judgment. Attorneys and Claimants cannot change the ultimate taxability of a claim to the Claimant by changing how the payment is structured. Therefore, a Claimant's tax liabilities cannot be shifted or waived by designating a different payee on the payment, such as to the Claimant's Attorney or a 3rd party. Designating additional or alternative payees serves only to trigger additional tax reporting for these payees.

Payments must be made as indicated in the settlement or judgment document, subject to adjustments to comply with state and federal tax withholding and reporting requirements. Settlement agreement or judgment language identifying the form that will be used for tax reporting purposes or the tax treatment of an amount will not be binding upon the Commonwealth and payments will be issued in accordance with this policy document. Departments issuing payments using Department funds must obtain prior approval of payment instructions before payment may be issued.

Payments will default to direct deposit if Claimant, attorney or payee is already set up for EFT on the state payroll or accounting systems. Some payroll claims will require payment over multiple pay periods.

The following are some of the payment options routinely requested or indicated in an award:

1. **Payable to Claimant, mailed to Claimant address (or direct deposit).** **Current** employee payments will be processed along with regular bi-weekly salary payments. **Former**

employees and non-employee payees will receive a check unless EFT is still active in the payroll or accounting system. This option may not be used for amounts representing attorney fees and costs, which must be paid directly to Claimant's Attorney.

2. **Payable to Claimant, mailed to Attorney or 3rd party address.** This option may not be used for current employees for **back pay** or **lump sum** damages, which require withholdings prior to payment. The payroll system cannot currently segregate regular salary from other types of payments. Therefore, these net amounts will be paid directly to Claimant along with regular salary. Payments to former employees (not currently employed by any other department on the payroll system) and to non-employees can be issued under this payment option. Payments issued under this option are delivered to the Attorney or 3rd party. Therefore, tax reporting is not triggered for the Attorney or 3rd party since they are not payees on the check.
3. **Jointly Payable to Claimant and Attorney or 3rd party, and mailed to Attorney or 3rd party address.** This option may not be used for current employees for **back pay** or **lump sum** damages, which require withholdings prior to payment. The payroll system cannot currently segregate regular salary from other types of payments. Therefore, these net amounts will be paid directly to Claimant along with regular salary. Payments to former employees (not currently employed by any other department on the payroll system) and to non-employees can be issued under this payment option. Payments made to additional Payees under this option will trigger tax reporting for the amount of the check, in addition to any tax reporting to the Claimant.
4. **Payable solely to Attorney or 3rd party and mailed to Attorney's address.** This option is used primarily for attorneys fees and payment directed to a 3rd Party. This option may not be used for current employees for **back pay** or **lump sum** damages, which require withholdings prior to payment. The payroll system cannot currently segregate regular salary from other types of payments. Therefore, these net amounts will be paid directly to Claimant along with regular salary.
 - Payments to former employees (not currently employed by any other department on the payroll system) and to non-employees can be issued under this payment option PROVIDED the Settlement or Judgment document identifies the payment solely to attorney or 3rd Party or a separate release has been signed by the Claimant requesting payment directly to the Attorney or 3rd Party. Payments made under this option to an Attorney or 3rd party will trigger tax reporting for the amount of the check, in addition to any tax reporting for the Claimant. This option will NOT shift any tax reporting or tax liabilities from the Claimant. The Commonwealth reserves the right to report any amounts issued to an Attorney or 3rd Party to the Claimant.

CTR will make best efforts to accommodate payment option requests within the parameters identified in this policy. When settlement or judgment documentation does not specify a particular payment option, the Counsel representing the Department should consult with Claimant's Attorney to determine the appropriate payment option.

EXAMPLES:

- **Former Employee** award of **back pay** \$2,356.00 and **attorneys fees/costs** of \$550.00.
 - o **Back pay** \$2,356.00 must be processed in the payroll system and check may be issued:
 - Solely to Claimant. Claimant will get W-2 for \$2, 356.00, OR
 - Jointly to Claimant and Attorney. Claimant will get W-2 for \$2,356.00. Attorney will get 1099-MISC (Box 14) for net of **back pay** amount.
 - o **Attorneys fees** \$550.00 may be paid:
 - Directly to Attorney through MMARS. Employee will get W-2 for \$2,356.00 and 1099-MISC (Box 3) for \$550.00. Attorney will get 1099-MISC (Box 14) for \$550.00, OR
 - Through payroll system (no withholdings taken) and a consolidated check of net **back pay** and attorneys fees issued to the Attorney. Employee will get W-

2 for \$2,356.00 and 1099-MISC (Box 3) for \$550.00. Attorney will get 1099-MISC (Box 14) for \$550.00 + net of **back pay** amount.

- **Current Employee** award of **lump sum** \$1, 500 and attorneys fees/costs of \$600.00.
 - o **Lump sum** must be processed in payroll system and will be processed in same manner as regular wages are paid (check or EFT/direct deposit). **Lump sum** amounts for current employees can not be segregated from regular wages and can not be cut in a separate check or made payable jointly to an Attorney/3rd party. Employee will get W-2 for \$1,500.
 - o **Attorney's fees/costs** will be processed through MMARS in separate check to attorney. Claimant will get 1099-MISC (Box 3) for \$600.00. Attorney will get 1099-MISC (Box 14) for \$600.00.
- **Non-employee claimant award** of \$6,000 with breakdown of **Lump-sum** \$5,000, interest of \$200.00 and attorneys fees/costs \$800.00. Payment Options:
 - (1) Single Check paid jointly to claimant and attorney for \$6,000 under attorney TIN (vendor code) broken up into \$5,800 (E52) and \$200.00 (E29).
 - 1099-MISC (Box 14) \$5,800 system generated to attorney
 - 1099-INT \$200.00 system generated to attorney TIN
 - 1099-MISC \$5,800 (Box 3) Manually issued to Claimant TIN

OR

Check #1 for \$5,200 paid to Non-employee claimant through MMARS under Claimant TIN (can be mailed to attorney address) \$5,000 (E50) and \$200.00 (E29)

Check #2 for \$800.00 attorneys fees paid directly to attorney under attorney TIN (E52)

- 1099-MISC (Box 3) for \$5,000 system generated to Claimant TIN
- 1099-INT for \$200 system generated to Claimant TIN
- 1099-MISC (Box 3) for \$800 manually generated to Claimant TIN (representing attorneys fees)
- 1099-MISC (box 14) for \$800 system generated to Attorney TIN (representing attorneys fees) * Note that both the Claimant and Attorney receive tax reporting on the same amount.

ADDITIONAL IRS EXAMPLES OF TAX REPORTING REQUIREMENTS

The IRS has identified a variety of examples of Tax Reporting Requirements for consideration when negotiating and processing claims. See: <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf> excerpted as follows:

Treasury Regulation 1.6045-5 provides examples of the reporting requirements in various situations involving the payment of lawsuit and settlement amounts. The regulation also outlines the defendant's, as well as the attorney's, obligations in situations where other firms or referral attorneys are involved.

Example 1. One check--joint payees--taxable to claimant. Employee C, who sues employer P for back wages, is represented by attorney A. P settles the suit for \$300,000. The \$300,000 represents taxable wages to C under existing legal principles. P writes a settlement check payable jointly to C and A in the amount of \$200,000, net of income and FICA tax withholding with respect to C. P delivers the check to A. A retains \$100,000 of the payment as compensation for legal services and disburses the remaining \$100,000 to C. P must file an information return with respect to A for \$200,000 under paragraph (a)(1) of this section. P also must file an information return with respect to C under sections 6041 and 6051, in the amount of \$300,000. See §§ 1.6041-1(f) and 1.6041-2.

Example 2. One check--joint payees--excludable to claimant. C, who sues corporation P for damages on account of personal physical injuries, is represented by attorney A. P settles the suit for a \$300,000 damage payment that is excludable from C's gross income under section 104(a)(2). P writes a \$300,000 settlement check payable jointly to C and A and delivers the check to A. A retains \$120,000 of the payment as compensation for legal services and remits the remaining \$180,000 to C. P must file an information return with respect to A for \$300,000 under paragraph (a)(1) of this section. P does not file an information return with respect to tax-free damages paid to C.

Example 3. Separate checks--taxable to claimant. C, an individual plaintiff in a suit for lost profits against corporation P, is represented by attorney A. P settles the suit for \$300,000, all of which will be includible in C's gross income. A requests P to write two checks, one payable to A in the amount of \$100,000 as compensation for legal services and the other payable to C in the amount of \$200,000. P writes the checks in accordance with A's instructions and delivers both checks to A. P must file an information return with respect to A for \$100,000 under paragraph (a)(1) of this section. Pursuant to § 1.6041-1(a) and (f), P must file an information return with respect to C for the \$300,000.

Example 4. Check made payable to claimant, but delivered to nonpayee attorney. Corporation P is a defendant in a suit for damages in which C, the plaintiff, has been represented by attorney A throughout the proceeding. P settles the suit for \$300,000. Pursuant to a request by A, P writes the \$300,000 settlement check payable solely to C and delivers it to A at A's office. P is not required to file an information return under paragraph (a)(1) of this section with respect to A, because there is no payment to an attorney within the meaning of paragraph (d) (4) of this section.

Records Management.

The Agency Counsel is responsible for maintaining the original or certified copies of all documents related to a claim or identifying the repository for these records in accordance with Record retention schedules published by the [Supervisor of Public Records- Records Management Unit](#). CTR will retain all documents submitted for processing, provided however that this does not relieve the Agency Counsel from the retention obligations for these records. The Public Records Law, G.L. c. 4, §. 7, 26 (c) exempts records from disclosure that are of a highly personal nature. Tax Forms (W-4, W-9s) and settlement or judgment information are deemed highly personal and confidential and may not be released without the individual's written consent. If a public records request is made, CTR is required to release the department name, the number of claims paid for a department, the amounts and the type of claims for a department. CTR has no authority to release any other information without the Department's validation that all exempted or personally identifiable information has been redacted and that the data subject has been notified if prior notice is required. Requestors will be referred directly to the Department for any request for such records.

Required Documentation for Claimants in case of tax audit. (Informational Only)

Claimants will be required to defend the tax returns related to settlement or judgment payments made to them or on his/her behalf to his/her Attorney or 3rd parties. The following information is excerpted from guidance the IRS provides to auditors when auditing tax returns for claims identifying the types of documents that Claimants may have to provide if audited:

"In cases where you [Auditor] do not have information to evaluate if the lawsuit proceeds were properly reflected on the tax return, you will need to issue an Information Document Request to the taxpayer requesting all or some of the following information, in relation to the lawsuit settlement or award, based on the facts and circumstances of your case:

- *A copy of the original petition, complaint or claim filed showing grounds for the lawsuit.*
- *A copy of the lawsuit settlement agreement, which clearly characterizes the payments.*
- *Copies of the settlement checks that you received. If copies of checks are not available, present a schedule of payments received. The information should include the payor information.*
- *Documentation of the amount of legal fees you paid, including any written fee agreements with your attorney.*

- Copy of the disbursement schedule or a clear statement of how the funds were disbursed.
- Documentation of letters or statements that your attorney provided to you that indicated that the lawsuit settlement proceeds you received were not taxable, if applicable. "

See Information Document Request for Claimants <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf>

Potential Claimant Penalties for tax returns that are not filed or unpaid taxes

The following information is excerpted from guidance the IRS provides to auditors when auditing tax returns and identifies the types of penalties that may be made against Claimants for failure to file tax returns with claim information, failure to pay taxes or failure to pay estimated taxes.

"For returns that are not filed, the following penalties should be considered:

- Failure to file penalty (IRC § 6651(a)(1))
- Failure to pay penalty (IRC § 6651(a)(2))
- Estimated tax penalty (For Individuals: IRC § 6654)
- Fraudulent failure to file (IRC § 6651(f))
- There is no reasonable cause exception to the IRC § 6654 penalty for underpayment of estimated tax by an individual. The penalties apply unless the taxpayer meets certain specified statutory exceptions. However, in the case of an individual, IRC § 6654(e)(3) provides that the Service may waive the penalty if the Service determines it would be inequitable, due to casualty, disaster, or other unusual circumstances. The Service may waive the penalty if the taxpayer has retired or became disabled during the taxable year. In addition, if it is determined that the underpayment was due to reasonable cause and not willful neglect the penalty may also be waived.

The failure to pay penalty applies to original and amended returns filed by the taxpayer. The Service may impose the failure to pay penalties where the taxpayer fails to file a return and a substitute return is prepared by the Service under IRC § 6020(b).

Lawsuit settlement cases usually result in significant adjustments to income. As in other cases where there are large amounts of unreported income, the accuracy-related penalty and fraud penalties must be considered. "

See Chapter 5 Penalties at p. 30 <http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf>

Internal Controls

CTR will conduct reviews of payments made by Departments using Settlement and Judgment codes and will conduct Quality Assurance reviews and audits as deemed appropriate. Departments will be responsible for making any corrections necessary to bring any settlements or judgment documentation or payments into compliance if a Department makes a payment contrary to the instructions in this Policy.

Information Sources

- Related Procedure
- Legal Authority – 815 CMR 5:00, G.L. c. 7A; relevant IRS and DOR tax reporting statutes
- Attachments
 - o Notice of Settlement/Judgment Tax Reporting And Withholdings, Claimant Receipt of W-2, 1099-MISC or 1099-INT Forms
 - o Table - Office Of The Comptroller 815 CMR 5.00 Payment And Tax Reporting Of Settlements And Judgments

- o Payroll Instructions for Employment Settlements and Judgments
- Forms – Non-Tort Settlement or Judgment Payment Authorization Form
- Contacts – CTR Help Desk
- Links –
- *Abrahamsen v. U.S.*, 4 Fed. Cl. 260 (1999) No. 99-5136 (Fed. Cir.) <http://www.ll.georgetown.edu/federal/judicial/fed/opinions/99opinions/99-5136.html>. (Payments of damages linked to salary and tenure considered wages and tax reportable.)
- *Amos v. Commissioner Of Internal Revenue*, United States Tax Court, No. 13391-01, Dec. 1, 2003. Court allocation of unspecified settlement amount into physical injury compensation (tax excludable) and nonphysical compensation (tax reportable) amounts.
- *Dewey v. United States of America*; <http://ca10.washburnlaw.edu/favicon.ico>
- G.L. c. 631, § 6I. Interest Rate; Schedule <http://www.mass.gov/legis/laws/mgl/231-6i.htm>
- [G.L. c. 152](#); [G.L. c. 152, §29](#)
- [G.L. c. 23E](#)
- [G.L. c. 258, § 10](#); [G.L. c. 258, § 9](#) and [G.L. c. 258, §9 A](#).
- [G.L. c. 30, §. 58](#)
- [G.L. c. 62, § 2](#).
- [G.L. c. 62B, § 1](#)
- [G.L. c. 62B, § 7](#) for penalties for failure to withhold taxes.
- [G.L. c. 7A](#) and 815 CMR 5.00
- *Hemelt v. United States*, 122 F.3d 204, 209-211 (4th Cir. 1997).
- [Internal Revenue Code § 3401\(a\)](#) “
- [Internal Revenue Code § 3401\(c\)](#)
- [Internal Revenue Code § 61](#) (Gross Income Defined)
- [Internal Revenue Code § 104](#) (Compensation for injuries or sickness)
- [Internal Revenue Code § 104\(a\)\(5\)](#) providing that for purpose of § 104(a)(2) “*emotional distress shall not be treated as a physical injury or physical sickness.*”)
- [Internal Revenue Code Section 3121\(a\)](#) “wages” consist of “*all remuneration for employment.*”
- [Internal Revenue Code Section 3121\(b\)](#) “employment
- [Internal Revenue Code Section 3402\(a\)\(1\)](#).
- IRC 104(a)(2) <http://www.fourmilab.ch/ustax/www/t26-A-1-B-III-104.html>
- [IRS Form W-9 Reporting of Gross Proceeds to Attorneys \(Final Regulations\)](#)
- IRS Instructions for Forms 1099-INT <http://www.irs.gov/instructions/i1099int/ar02.html>
- IRS National Office Technical Advice Memorandum #200244004, 11/01/2002, TAM-130245-01 <http://www.irs.gov/pub/irs-wd/0244004.pdf>
- [IRS Private Ruling No. 200041022](#), Oct. 13, 2000. IRS private letter ruling on gross income in relation to physical injury damages, both pre-injury and post-injury, and reportable punitive damages.
- IRS Public Letter Ruling PLR – 101732-00, #200041022, 10/13/2000 Index # 104.03-00, <http://www.irs.gov/pub/irs-wd/0041022.pdf>
- IRS Publication 15 <http://www.irs.gov/publications/p15/index.html>
- IRS [Publication 525](#), Taxable and Nontaxable Income.
- IRS [Publication 525](#), Taxable and Nontaxable Income. <http://www.irs.gov/pub/irs-pdf/p525.pdf>

- IRS Revenue Ruling 80-364 <http://www.legalbitstream.com/scripts/isyswebext.dll?op=get&uri=/isysquery/irlcdf/1/doc>
- IRS [Tax Topic 422](#), Nontaxable Income
- IRS Topic 403 - Interest Received <http://www.irs.gov/taxtopics/tc403.html>
- IRS Topic 515 "Casualty, Disaster, and Theft Losses" <http://www.irs.gov/taxtopics/tc515.html>
- [Jalali v. Root](#), 109 Cal. App. 4th 1786 (Cal. App. Ct. 2003) (Malpractice case against attorney for "incompetent tax advice" overturned solely because law on taxation of Attorney fees uncertain.) This defense is no longer available given the United States Supreme Court's recent ruling that attorney fees constitute income to Claimant and are tax reportable, with the exception of a limited exemption for employment discrimination claims. See [Commissioner v. Banks](#), 543 U.S. ___, 125 S. Ct. 826 (2005).
- Lawsuit Awards and Settlements: IRS Tax Law, Weitz and Luxenberg P.C. at http://www.weitzlux.com/irs/freetaxeslawsuitsettlementirs_920.html
- Public Letter Ruling PLR - 101732-00, #200041022, 10/13/2000 Index # 104.03-00, <http://www.irs.gov/pub/irs-wd/0041022.pdf>
- [Ramey v. Commissioner](#), T.C. Summary Op. 2001-156 No. 1776-00S (9-26-01) (ruling that back wages, liquidated damages Attorney fees and costs were taxable because these were not excludable under IRC 104(a)(2) as not received on account of personal injury.
- Revenue Rule 80-364 <http://www.irs.gov/pub/irs-wd/0009046.pdf>
- [Revenue Ruling 96-65](#) - Back Pay and Emotional Distress not received on account of Personal Injury.
- [Social Security Board v. Nierotko](#), 327 U.S. 358 (1946) <http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=us&vol=327&invol=358>,
- [Valia v. Commissioner](#), Tax Court Summary Opinion 2005-17 <http://www.ustaxcourt.gov/InOpHistoric/valia.sum.WPD.pdf>;
- [Williams v. Commissioner](#), Tax Court Memo, 2005-29, <http://www.ustaxcourt.gov/InOpHistoric/willia5ms.TCM.WPD.pdf>
-